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FIRST SESSION

THURSDAY, MAY 17, 9:30 A. M.

The Ohio Union—West Ballroom

Presiding:

FRED C. DENNIS, *President, The Ohio Society of Certified Public Accountants; Partner, Lybrand, Ross Bros. & Montgomery, Cincinnati, Ohio*

Paper: "Management Advisory Services in the Accounting Field"

PAUL GRADY, *Partner, Price Waterhouse & Co., New York, N. Y.*

Paper: "Responsibilities of the Accounting Profession"

JOHN H. ZEBLEY, JR., *President, American Institute of Accountants; Partner, Turner, Crook and Zebley, Philadelphia, Pa.*

MANAGEMENT ADVISORY SERVICES IN THE ACCOUNTING FIELD

By

PAUL GRADY

Partner Price Waterhouse & Co., New York

Management advisory services have been an integral part of the work of the accounting profession from the beginning. I recall seeing a letter dated about 1880 from an accounting firm, the back of which carried a colorful picture illustrating the merits of that firm's system and procedures services. The picture showed a "before" and "after" sequence. The "before" portion depicted a poor wretch on a high stool struggling with an ink-spattered ledger, with a companion scene of his lonesome wife and children having dinner without benefit of father's presence. After the system services, the ledger was shown to be neatly balanced by closing time and the happy dinner scene included all members of the family. So much progress has been made in methods and procedures that this bit of Americana appears crude to us today. It is also to be hoped that in the last three quarters of a century some progress has been made in diminishing the flavor of commercialism evidenced in the manner of calling attention to the professional accountants services in this area.

The past 10 or 15 years have witnessed considerable expansion of management advisory services in the field of accounting. These demands for increased professional accounting assistance to business have resulted from many causes including the need to improve control, the need to reduce costs, particularly overhead clerical costs, and the need for better and more timely information required for business decisions. The expansion of client demands for these services has caused the accounting firms to extend specialization both in numbers of personnel and in the area of services.

Any discussion which does justice to the importance of these services may result in an impression that the accounting profession is on the verge of abandoning its role as independent auditors and tax consultants. Therefore before undertaking a description of certain types of management advisory services I should like to make clear that in my judgment the principal function and responsibility of the accounting profession will continue to be the examination of the financial statements of business enterprises and rendering opinions on such statements. Management advisory services are probably less than 10 per cent of the total services rendered by the accounting profession. These, as well as tax services, are logical collateral activities to our major role, even though training and experience in fields other than accounting may be required, because the general knowledge of the enterprise obtained in annual examinations is most useful background information to facilitate the exercise of judgment in the special services.

Management advisory services and the examination of financial statements have a common anchorage which is internal control. This may be seen from the following excerpt from the special report issued in 1948 by the Committee on Auditing procedure of the American Institute of Accountants:

> "Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognized that a 'system' of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments. Such a system might include budgetary control, standard costs, periodic operating reports, statistical analyses and the dissemination thereof, a training program designed to aid personnel in meeting their responsibilities, and an internal audit staff to provide additional assurance to management as to the adequacy of its outlined procedures and the extent to which they are being effectively carried out. It properly comprehends activities in other fields as, for example, time and motion studies which are of an engineering nature, and use of quality controls through a system of inspection which fundamentally is a production function.
>
> "What may be said to be characteristics of a satisfactory system of internal control? Certainly, they would include:
>
> > A plan of organization which provides appropriate segregation of functional responsibilities,
> >
> > A system of authorization and record procedures, adequate to provide reasonable accounting control over assets, liabilities, revenues and expenses,
> >
> > Sound practices to be followed in performance of duties and functions of each of the organizational departments, and

A degree of quality of personnel commensurate with responsibilities."

The report deals with the fact that management necessarily has the responsibility for devising, installing and supervising the system of internal control and that the broad design and integration of the system demand careful planning. The report also points out that:

"Effective internal control is so pertinent to the question of the reliability of financial data and so fundamental to a proper discharge of management's total responsibility as to require that management be prepared to demonstrate the steps taken to attain it. A chart of accounts testifies to the adequacy of a plan of accounts, and a properly prepared procedures manual provides a standard with which the actual procedures in use may be compared to detect departures which may afford opportunities for irregularities whether fraudulently conceived or otherwise. Detailed description in a procedures manual may be greatly simplified if management will develop and utilize a visual plan of organization and of the flow of transactions. Wholly apart from the day-to-day contribution which they make to good management, soundly conceived charts of accounts, well written and complete manuals of accounting policies and procedures, and organization and flow charts obviously greatly facilitate the puublic accountant's review of internal control, and by their orderliness, contribute materially to a higher quality of review."

While the primary responsibility for establishment and enforcement of internal control measures rests with management, the degree to which such measures exist and are carried out is of great concern to the public accountant. One of the generally accepted auditing standards is:

There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

The special report of the Committee on Auditing Procedure gives general guidance on the study of the system of internal control and states that:

"The public accountant's review of the system of internal control serves two purposes; first, it enables him to formulate an opinion as to the reliance he may place on the system to the end that, by adjusting his audit procedures accordingly, he may express an opinion as to the fairness of management's financial statements; and, secondly, where the review indicates apparent weaknesses, recommendations for possible corrective measures may be conveyed to management. This secondary aspect of his review frequently enables the public accountant to render broader services than those generally associated with his capacity as an independent reporter to stockholders upon management's conduct of stewardship responsibilities. His aid to management in attaining more efficient operation can and should be an equally important function."

These few excerpts clearly demonstrate the bond between auditing and management advisory services. It is such a natural and close relationship that the public accounting profession could not avoid furnishing these advisory services to its clients even if it so desired. The information obtained in reviewing the effectiveness of organizational plan, division of responsibilities, budgetary controls, reports, analyses and cost systems of the particular client and of other companies with somewhat comparable operations places the public accountant in a preferred position to render constructive advice and assistance in these areas at a minimum of effort, cost and inconvenience to the client's organization.

It has never been feasible or desirable to define and catalog all possible services because of the variety and changing scope of management requirements. However, it may be of interest, particularly to the accounting faculty members present, to summarize some of the principal services included in the broad category. The firm of which I am a member has prepared a small pamphlet for the information of staff and clients in which the following subjects are dealt with as the principal areas for management advisory services:

Administration:
- Organization Structure
- Budgetary Control
- Management Reporting
- Compensation and Benefit Plans

Accounting and Office Management:
- Cost Accounting and General Accounting
- Mechanization of Clerical Work
- Application of Electronic Data Processing Equipment
- Clerical Methods and Work Standards
- Forms Control and Records Retention

Manufacturing:
- Production and Inventory Controls
- Materials Handling

Internal Methods Groups:
- Consultation with Company Methods Personnel

Although any experienced accountant will know a great deal about advisory services as here broadly delineated, the successful performance of such services requires various types of specialization by numerous members of an organization. Considerable time must be devoted to assembling up-to-date information bearing on the solution of management problems including the latest developments and even probable future developments of the leading business machine manufacturers. This means the maintenance of an extensive specialized library and the development of methods for keeping members of the organization appropriately informed in their areas of specialization.

Recent years have witnessed phenomenal progress in scientific and applied engineering technology. There has been corresponding progress in business management of a scientific approach, or perhaps more accurately an artistic approach, through recognition of the necessity of planning, organization and rationally designed measuring and control processes which we call accounting. An interesting story of the progress of one important company was told in the *Journal of Accountancy* a few months ago by Ernest R. Breech, Chairman of the Ford Motor Company. Mr. Breech's views as to the usefulness of accounting and budgetary reports as essential tools in the management process may be accepted as fairly typical of present day business leaders.

Perhaps it should be said that one of the causes of executive managements greater appreciation of accounting and budgetary reports is that the controllers and public accountants, through management advisory services, have finally fashioned them into useful tools. Much of the improvement has come from recognition that what has happened in the past is of lesser importance to management than what is going to happen in the future under predicted conditions. In other words accounting has had to become more than an historical scorekeeper. Another important source of improvement has been the design of charts of accounts and of operating and budgetary reports to synchronize with departmental functions and responsibilities as set forth in the company's plan of organization. In this way the reporting system will supply information as to performance attained in comparison with that expected, based on predetermined estimates or standards, in direct identity with the officials or employees having responsibility for a given activity.

Most management advisory engagements would relate to several of the principal services previously summarized due to the inter-relation of organization structure, budgetary control, reporting, accounting, mechanization and methods and procedures. In handling these engagements, those who are most successful bring into play not only technical competence but qualities of imagination, creativeness and ability to work harmoniously and convincingly with other people. The demands for accountants having these qualities are far greater than can be met and probably this will always be true.

A few months ago there was an interesting article in the London *Economist* which developed a formula called Parkinson's Law demonstrating the normal rate for growth of bureaucracy regardless of work load. Such a tendency undoubtedly exists in any administrative function whether government or business. Capable management knows that counteraction must be sought through alert supervision and by work simplification.

The term "work simplification" is used in its broadest sense which includes the elimination of any unnecessary work and the finding of the easiest and most economical way of performing the work that is necessary. The initial reaction to work simplification by some people is that it is a "speed-up" program. Quite the contrary, it means working more intelligently and with less effort by improving procedures, forms, routines, machines and working space.

The need for improvement and simplification has caused many companies to establish permanent methods and procedures divisions. Outside consultants are also often engaged to assist in the work simplification programs. The use of outside consultants is not necessarily an alternative procedure to the establishment of a methods division. In our own firm approximately 50 per cent of the work of our management advisory services department is for clients with their own methods divisions. This is attributable to the need for the advice of highly qualified specialists in various phases of the work and to the general value of an outside independent viewpoint.

The work simplification procedure necessarily involves detail studies of the methods and procedures employed in the performance of the various tasks under consideration. This phase of the work is, of course, greatly simplified where adequate and up-to-date procedures manuals are available. After the fact-finding is completed, the present methods must be evaluated and challenged in order to identify the uneconomical use of personnel, machines, space and supplies. The final steps are designing more effective methods and placing them into effect.

The men who specialize in this type of work have quite naturally developed their own special tools to expedite their work and to demonstrate comparative performances under the new and old methods. So when you get into a work simplification program you will probably hear a great deal about "flow process charts," "process layout," "activity charts," "forms analysis," "motion analysis" and "output measurement." One of the interesting developments is the use of motion pictures as an improved technique in measurement of clerical operations. After the film has been made it may be shown at any desired rate of speed which greatly facilitates accurate time measurement of the various elements making up a total task and greatly aids in the identification of uneconomic effort of both personnel and machines.

The primary condition for a successful work simplification program is the development of a spirit of cooperation between the persons undertaking the required survey work and the persons responsible for the operation of the procedures under study. Cooperation is usually readily obtained where the employees are fully advised of the objectives and nature of the program: that it is in no sense a "speed-up" and that excessive personnel will be taken care of through the regular turnover rather than by dismissal. Most employees welcome an opportunity to participate actively in a program which will increase productiveness without greater effort, and excellent improvements often flow from their suggestions.

If we view the whole pattern of our industrial system it is probable that the greatest progress in streamlining working methods has been in the manufacturing processes. This has happened because of the continuous attention given to the problem over many years by the best business, engineering, accounting, and inventive talent of America. The productivity resulting from the improved methods and equipment is one of our greatest contributions to modern civilization as well as our strongest defense against predatory powers. The accounting tool most commonly associated with streamlined production methods has been budgetary control through standard costs and other cost accounting techniques. By developing standards for the performance of various operations management is furnished predetermined yardsticks by which actual performance may be judged. There can be no doubt that the knowledge afforded management by the studies of the processes necessary for the establishment of standards as well as by the subsequent comparisons with actual performance has greatly aided in the elimination of uneconomic production costs.

The area of costs and standards may be expected to continue to furnish important opportunities for management advisory services. More recently progress has been made in extending the application of cost and performance standards to clerical work. The accounting department is a service department, in the sense that it is not an end in itself, but it is also an operating department in relation to the vast volume of paper work which has to be done. A major part of the task of the accounting department is to "manufacture" the millions of checks to vendors' invoices, time cards and other supporting documents to make the billings to customers and to produce the thousand and one management reports in accordance with established specifications. The manual efforts of personnel and the utilization of machines in the great volume of clerical operations are just as adaptable to the establishment of standards as are manufacturing operations. This is readily discernible from the simple nature of repetitive clerical operations such as sorting, filing, comparing figures, writing checks, billing, posting, extracting data from tables, etc. Standard costs must be determined in relation to the methods in use and the standards may be stated both in unit costs and in period dollar costs for each measurable activity. The establishment of standards requires the same type of analytical fact-finding and evaluation processes as previously described in work simplification and really represents a logical further refinement in a work simplification program.

Some of you may have wondered whether accountants are not getting into industrial engineering when they deal with time measurement factors and with production and inventory controls and material handling. The answer is that they are, but that in many cases the physical problems are so closely related to the clerical routines that they must be straightened out as a joint problem. For example, an excellent inventory control system may not produce good results if the storeroom is so poorly arranged that inventories cannot be readily found, or if parts and supplies pass through several uncontrolled storage areas before their point of use. Similarly, regardless of the excellence of the accounts payable procedures, they will not be effective if the receiving and incoming inspection departments cause long delays in record preparation because of inadequate space, inadequate equipment or inadequate procedures or if such departments lack the physical facilities to prevent removal of parts by other departments before their arrival has been recorded. Therefore, the accountant is forced to tackle some of the simpler physical problems of layout, materials handling, and storage. Accountants would not undertake strictly industrial engineering projects such as product design, establishment of manufacturing methods and design of equipment because they do not have the required competence and the areas are not integrated closely with the design of procedures.

A substantial segment of management advisory services relates to the proper use of office machines. Truly remarkable progress has been made in the tools available to perform clerical chores. If the equipment of 10 years ago was lined up with today's models the contrast in speed and capacity would be astounding. Several new and highly efficient duplicating methods have been developed; new high-speed addressing techniques are available; bookkeeping machines will soon be able to select posting lines and pick up old balances automatically from magnetic spots on ledger cards; previously unrelated machines have been linked into integrated groups through the medium of common language tapes; and finally, the electronic data processing machines have brought into view new horizons beyond the scope of our dreams.

The computational, memory and decision making abilities together with the phenomenal speed of this advanced equipment are forcing us to reconsider our basic approaches to practically all of the accounting processes and other data processing routines of large business enterprises. Management advisory services of accounting firms have been widely used to make feasibility surveys to evaluate the economic and other advantages which may be reasonably expected from the use of the electronic data processing systems. After decisions have been reached to use the equipment, accounting firms are assisting clients with equipment specifications, programming, training personnel, installation, internal control and other related problems. Although we are in the early stages of finding out how to utilize these machines to the best advantage, sufficient progress has been made to demonstrate that the impact on administrative, planning and accounting practices will be truly revolutionary.

It has been my great privilege to be associated with both the first and second Hoover Commissions. In essence these were large-scale management advisory surveys of the executive departments and agencies of the federal government. Mr. Hoover has said that practically everyone in the government thinks the recommendations are splendid—except those affecting his own department. Management advisory recommendations in the accounting field usually meet with a more enthusiastic reception. It is fortunate that business has such a keen interest in improving internal control, efficiency and the quality of budgetary and accounting reports. The sinews of our economic structure must be kept lean and strong in order to support the tremendous cost of government and continue to provide an improved standard of living for the American people.

RESPONSIBILITIES OF THE ACCOUNTING PROFESSION

By

JOHN H. ZEBLEY, JR.

Turner, Crook and Zebley, Philadelphia

Public accounting has been said to be the fastest growing profession in the world today. The opportunity for further growth and recognition as a profession was never better.

However, there continues to be a growing need for distinguishing between the keeping of books of account, on the one hand, and being engaged in the professional practice of public accounting, on the other hand. Some of those present today have had occasion to discuss with legislators the necessity for high standards of eligibility of candidates for the CPA certificate. I am sure they could testify that a lack of understanding continues to exist in the minds of some of our lawmakers as to the difference between a bookkeeper and a CPA.

A well known CPA, a Past President of the American Institute in fact, tells of a remark that his daughter made when she was in her early teens. She said, "Daddy, I wish you were a butcher." Naturally he was prompt to inquire why. Her reply was, "It would be so much easier to explain to my friends what you do."

Business facts are expressed through the medium of accounting. The activities of an enterprise are thus made understandable. Transactions are recorded in terms of a medium of exchange. They are classified according to their nature by accounts, grouped in functional categories. Then they are summarized with regard to periods of time.

These steps are known as bookkeeping and are quite necessary as a preliminary to reporting on and interpreting the results of business. Bookkeeping is a part of accounting, but it is only a part, and by no means the whole.

The determination of the accuracy of the bookkeeping — the recording, the classifying, and the summarizing — is known as auditing and is one of the principal responsibilities of the CPA.

The greatest usefulness of accounting has been attained in reporting upon and interpreting the results of business transactions and it is in this field that the professional responsibilities of public accounting have been more fully developed.

It is well recognized today that the magnitude of some businesses is such that successful management would be impossible without adequate accounting and financial information.

Indeed in recent years it has become increasingly apparent that the small businessman is just as much in need of adequate financial information about his business as is the executive of the large manufacturing concern. Along these lines, Mr. Milton J. Drake, Vice President of the Detroit Bank, Detroit, Michigan, has been recorded as stating:

> "The education of the small businessman to supply adequate financial information has been a long and slow road for the bankers and requires unremitting efforts on their part if it is to continue. The banker certainly cannot afford to lower the bars in his demands for financial information merely because the business is small. In fact, if a small business does not have adequate financial information the banker should be more than normally alert and on guard because he will recognize that the businessman cannot run his own business adequately without such information. Certainly a lack of this information should be a clue to the banker that the businessman is not modern in his thinking and is trying to run his business by the seat of his pants instead of in any logical fashion based on the results indicated by complete financial information."

The primary contribution of the Certified Public Accountant to the economy of today is the expression of his opinion, after an impartial and objective examination, as to the fairness of the presentation of the information embodied in financial statements used by management, by investors and owners, by government and by credit grantors. Of course, it is true that his activities may and do extend through many other fields related to accouning, such as system installation, tax practice and practice before regulatory bodies. But first and foremost, the CPA is an unprejudiced auditor of the accounts kept by others and an unbiased reporter on the fairness of the presentation of financial facts prepared by others in statement form.

The members of the profession of public accounting have ethical responsibilities. In using the words a bit ago "unprejudiced auditor" and "unbiased reporter" I assure you that I did so advisedly and with full appreciation of the connotation of independence which such language definitiely conveys.

Somewhere it has been written, "A moral code is the basis of professionalism." Elsewhere appears, "The profession, serving the vital needs of man, considers its first ethical imperative to be altruistic service to the client." A third person has written, "Professional men must maintain their own ethical standards because their clients and the public rarely have the technical competence to judge the quality of professional work."

Such definitions or concepts or professionalism might be said to indicate general attributes. More specifically with regard to public accounting, certified public accountants have fostered and developed among others the following specific attributes:

1. The determination of prerequisites of education and training for entrance to he profession.

2. The matters covered by rules of professional conduct, particularly the concept of independence.

3. The development of generally accepted accounting principles and auditing standards.

4. General participation in the advancement of the capacity to serve the public.

Following the turn of the century the CPA's organized themselves into local, state and national groups, as the number granted certificates increased and spread across the country. By means of these groups communication has been maintained and questions of importance to the development of public accounting as a profession have been considered and resolved. The American Institute of Accountants, being the national organization of Certified Public Accountants, has assumed leadership in these endeavors.

All of you, I am sure, are familiar with the fact that the examination for a certificate as a Certified Public Accountant, whether taken in Maine or in California or in the District of Columbia or in the territorial possessions of the United States, is uniform as to content and as to timing. This is true even though 54 separate boards of accountancy administer the admission requirements and conduct the examinations. This uniformity is accomplished because the examination is prepared under the auspices of the Board of Examiners of the American Institute of Accountants. All but two of the boards of accountancy using the examination service now send their papers to the American Institute for grading by the staff of CPA's especially assembled for this purpose. This group is instructed and supervised in its work by Robert L. Kane, Jr., the Director of Education of the American Institute. Thus almost complete uniformity in the grading of the examination papers also exists.

However, there is need for greater uniformity in prerequisites of education and training of candidates for the CPA certificate. Such prerequisites are set by the law or the regulations of the State Board in each state separately without regard to the provisions of other states on the subject. For several years a commission on standards has been studying the interrelationship of education and experience in the CPA examination. The commission is composed of educators, board members, and CPA's in practice. It is hoped that the report of the commission will be released this year. I do not intend to anticipate its findings but there can be no doubt that the CPA of the next generation—perhaps that is too far off maybe I should say of the next few years—will have to be better educated, better informed, and more broadly experienced in many phases of accounting practice than his predecessors.

I know that it will be no easy task to raise standards in the face of continuing criticisms to the effect that the CPA examination is too difficult, with political pressures in almost every state to make it easier to become a CPA. However, the growing complexities of business and the growing demands upon the services of CPA's make it necessary for us not only to maintain but to raise our profession standards.

I have said that Certified Public Accountants have developed ethical standards. The concept of independence which is implied throughout the rules of professional conduct of the American Institute although not directly mentioned, is in some respects peculiar to the accounting profession. It is subjective and emphasizes the impartial attitude of mind and purpose with which the CPA conducts his examinations.

The Executive Committee of the American Institute of Accountants in 1947 in a statement of independence said in part:

> "Rules of conduct can only deal with objective standards and cannot assure independence. Independence is an attitude of mind, much deeper than the surface display of visible standards. These standards may change or become more exacting but the quality itself remains unchanged. Independence, both historically and philosophically, is the foundation of the public accounting profession, and upon its maintenance depends the profession's strength and its stature."

Another matter closely related to the rules of professional conduct, although not specifically included there, deals with the release of financial statements with which the name of the CPA is associated. It is a pronouncement of the committee of auditing procedure of the American Institute of Accountants known as statement No. 23.

The provisions of statement Number 23, which has been formally adopted by the membership of the American Institute, recommend that an independent auditor in any report on financial statements with which his name is associated (1) express an unqualified opinion of the fairness of the financial statements or (2) express a qualified opinion with permitted exceptions indicated, or (3) state clearly that he is unable to express an opinion and the reasons for the omission, or (4) indicate that the statements have been prepared without audit.

The purpose of statement Number 23 is to require the auditor to make clear the degree of responsibility that he takes with regard to the financial statements with which his name is associated. It is the absence of clarity in the auditor's report which has generally led to claims for damages being asserted against CPA's on occasions in the past, and sometimes being successfully sustained.

In my opinion excellent protection is afforded the CPA who follows the provisions of statement No. 23, against claims for damages based upon alleged deviations for generally accepted standards of auditing and of reporting.

I believe we can say with confidence that our rules of professional conduct compare favorably with the highest in any profession. Nevertheless, our very growth in numbers, and the widening of the areas of practice raise new questions which inevitably lead to increasing vigilance in the area of professional ethics in the immediate future.

Recognizing the need for some action along these lines, the ethics committee of the Institute last October presented to the council a list of 15 points which it recommended be intensively studied to determine whether any changes in the rules of professional conduct should be proposed to the membership. The subjects suggested for study are:

1. Should not the rules of conduct include a statement of the accounting profession's concept of "independence" to avoid erroneous interpretation by government agencies and the courts?

2. Should not the publication of cards in public prints announcing changes of address or partnership be abolished, and merely permit a mailing of announcements of such changes to clients and personal acquaintances?

3. Should not the present permission to indicate "class of service" on cards and letterheads be abolished?

4. Should not contingent fees in all matters be prohibited?

5. Should not there be issued a statement of the ethical responsibility of Certified Public Accountants in furnishing mechanical or electronic statistical or data processing services?

6. Should not there be a statement concerning the ethical responsibilities of Certified Public Accountants in tax practice?

7. Should not the committee issue a statement on the ethical responsibilitiies of Certified Public Accountants in management services?

8. Should not the rules of professional conduct prohibit the preparation by members in public practice of legal documents as listed in the joint statement of tax practice, to wit: agreements, conveyances, trust instruments, wills, or corporate minutes?

9. Should not employed lawyers with accounting firms be prohibited from doing anything a Certified Public Accountant is not authorized to do?

10. Should not the formation of new partnerships with non-certified Public Accountants be forbidden?

11. Should not the committee issue a statement of the ethical responsibility of members in public practice to train their employees?

12. Should it not be considered a breach of professional conduct for a member of the Institute to speak unfavorably of a colleague?

13. Should not there be a rule of professional conduct requiring notification to existing auditors by a firm succeeding them on an accounting engagement?

14. Should not the rules of professional conduct be amended to require compliance with statement 23?

15. Should not ways be explored for collaborating with government agencies, credit grantors, state societies and others, to ascertain instances of non-compliance with the Institute's rules of professional conduct?

For the purpose of making a study of the points enumerated I appointed a special advisory committee consisting of 10 members under the leadership of Frank L. Wilcox, Chairman of the Committee on Professional Ethics.

The study has been divided into three areas, (a) ethical questions related to preparation of legal documents and employment of lawyers by CPA's (b) ethical conduct in areas other than auditing and tax practice, and (c) accountants' ethical responsibility in tax practice. The committee has organized within itself three subcommittees with each group undertaking a preliminary study of one of the areas mentioned. It is hoped that some exposure of the thinking of the subcommittees on some of the subjects may be made before the next annual meeting of the Institute.

It is quite apparent that the members of the accounting profession are the custodians of techniques and methods of record-keeping and financial reporting that are indispensable to our present economy. It is this discipline, which deals with the application and development of sound principles of accounting, that forms the foundation upon which the whole structure of the accounting profession is built.

The American Institute of Accountants makes no claim that it is the only organization which is conscious of the responsibility of Certified Public Accountants in this field or which is active in continually striving for the improvement of techniques and the development of standards in accountancy. The contributions made by university instructors in accounting, whose work has been coordinated through the American Accounting Association, have been most important. Likewise, the efforts developed through the activities of the American Petroleum Institute, the Controllers Institute, the Institute of Internal Auditors, and the National Association of Cost Accountants have contributed substantially to the formation of the vast body of accounting conventions which comprise tthe foundation for sound accounting principles.

Underlying the contributions made by these other organizations to this most important aspect of professionalism in accounting, will be found the tireless efforts of the Certified Public Accountants who have become affiliated with those organizations. This in no way detracts from the accomplishments of those groups; it merely emphasizes the importance that attaches to the foundation and the protection of sound accounting principles in the minds of so many Certified Public Accountants.

Care must be continually exercised, however, that pressures exerted through changing methods of taxation or caused by the exigencies of business have no untoward effect on the determination of accounting concepts and principles generally applicable for financial reporting purposes.

An example in point are transactions which fell within the scope of section 462 of the Internal Revenue Code. The books of account of many taxpayers recorded the accrual of the particular expenses in 1954 as being in conformity with sound accounting practices and claimed the new tax deduction. Section 462 was acclaimed as a step forward in bringing tax accounting into closer relationship with general accounting. Then the Treasury Department changed its mind on this subject, because of revised estimates of revenue loss, and invalidated the deduction for tax purposes of the accrual of such special expenses. For those who accepted the invitation, changed accounting methods, and claimed the deduction, there should be no reversal of method just because the deduction is not being allowed. Such accounts do conform to what has been stated publicly to be sound accounting practice. But what about the accounts of others, in the same industry perhaps, that did not change methods and made no effort to claim the tax deduction? Should it be said that the accounts of such concerns are no longer being maintained in accordance with sound accounting practices? There is yet much to be done to reconcile financial reporting with tax accounting.

In the profession of public accounting, which by comparison with law and medicine is relatively young and may be expected to grow by expansion of its services to others, there must be a continual striving for greater knowledge, for improvement of techniques, for further refinement of principles and standards.

The challenge in this respect is to continue to improve the usefulness of the financial statements prepared in accordance with generally accepted accounting principles by regularly exploring the applicability to current situations of principles which may have had unchallenged validity in the past.

It could be that greater progress might have been made in the development of the report of the auditor had it not been thought necessary or desirable for one form of financial statements generally to be acceptable for all purposes. The financial information desired by credit grantors is not always the same as that which labor groups might like to have. Analysts and investors sometimes use other data for their measurement of the degree of success attained by the management of an enterprise.

The American Institute has generally encouraged the use of supplemental statements where additional information seems to be desirable. Recently an effort has been made to develop standards of reporting for special types of financial statements, such as cash basis statements and statements of non-profit organizations. No doubt some pronouncements along these lines will be forthcoming soon which will deal with the use of the term "generally accepted accounting principles" in connection with such special reports.

Research into and periodic testing of the usefulness of current accounting principles are necessary to the maintenance of their acceptance by the profession as a whole. The lead in this respect must be maintained by the profession; otherwise accounting principles and standards may be developed by government edict, or what would be worse, by unfortunate litigation.

Above and beyond our own problems and responsibilities, our emergence in size and prestige as a full-fledged profession inevitably brings with it greater public and social responsibilities. With 53,000 Certified Public Accountants in the United States, and more than 27,000 members of the American Institute, we must be expected to exercise our influence for the public good, and to serve our communities and our national, state and local governments in proportion to our resources. The recent appointments of a number of Certified Public Accountants to high positions in the federal government are both a welcome recognition of the contributions which the profession can make, and evidence that our members are willing to make the contributions.

I believe, however, that we should recognize our public responsibilities not only as individuals, but as an organized profession. I am therefore very happy that the Executive Committee and Council of the American Institute have approved a recommendation that we should explore new possibilities of public service in areas where accountants may have a special contribution to make. As one step in this direction, we are considering ways in which the accounting profession can make a contribution toward the solution of the acute problems of our public schools—and I do not mean segregation!

We have a double interest and responsibility in this area. First, as accountants, we should be able to help in evaluating the need for funds for school purposes, and also in making sure that the available funds are used as efficiently as possible. Second, as one of the professions, we may be adversely affected by and need to be deeply concerned with quality of primary and secondary school education which is being offered to the next generation. I am sure most of you in public practice have voiced the common complaint about many junior accountants today—that too many of them cannot write a clear English sentence. Indeed there are some who say they just cannot write, period.

If any of you has ever served on a school board or audited a school district, you will be aware of the fact that our school systems have been slow to adopt modern methods of accounting for costs and of business management. There is no doubt that better accounting throughout our school systems generally could make available, for more constructive purposes, many millions of dollars which if not wasted may at least be said to have been unwisely spent.

As one specific item, I appointed this year a special committee of Institute members with appropriate background and experience, to review critically a forthcoming National School Accounting Manual which is being brought out under the auspices of the United States Office of Education, the Association of School Business Officials, and some other groups. This will be, I hope, the beginning of many contributions which the accounting profession can and should make to the betterment of our schools.

The rendering of public service is one of the most important signs of maturity in an individual or an organization. For a profession, it means not only willingness to serve, but also public recognition of the important place occupied by the profession in our society. I do not mean that we undertake public service to gain recognition; rather, as we achieve public recognition and acceptance, our opportunities and our obligations to bear our share of the common burdens become increasingly greater.

The professional accountant is coming of age in this exciting and expanding world in which we live. We already have a long and honorable tradition, but in numbers, in the importance of what we do, and in what is expected of us, our development since World War II is fully comparable to the other remarkable changes and marks of progress that we see all about us. We live in a world of such rapid and extraordinary growth that it is almost beyond comprehension. The accounting profession is an integral part of this growing world, and is representative of one area of the basically important technical developments which have made the growth possible.

We face important problems, in accounting techniques, in taxation, in our professional development, and in the field of public service. How we solve these problems, I venture to think, has a significance beyond the techniques of accounting, even beyond the standards and the ethics of our profession.

In this world where our concepts of economic freedom are matched against totalitarian controls, the independent accountant's standards of full disclosure are important not only for their own sake, but also as a symbol of our belief that free men acting in the light of day will always prove superior to those who are governed in secrecy and darkness. Accounting and accountability are key words in our day-by-day proof that a free society can also be the most efficient society.

I am proud to believe that Certified Public Accountants as individuals, and the accounting profession as a whole, have the vigor and the imagination to live up to the responsibilities which the future will place upon us.

SECOND SESSION

THURSDAY, MAY 17, 1:00 P.M.

The Ohio Union—East Ballroom

Presiding:

FRED C. DENNIS, *President, The Ohio Society of Certified Public Accountants; Partner, Lybrand, Ross Bros. & Montgomery, Cincinnati, Ohio*

Presentation of The Ohio Society of Certified Public Accountants award to highest C. P. A. candidates in the Fall 1955 examination: Caryl J. Porter and Donald C. Opatrny

THIRD SESSION

THURSDAY, MAY 17, 2:30 P.M.

The Ohio Union—West Ballroom

Presiding:

CHARLES R. ISRAEL, *President, National Association of Cost Accountants; Treasurer, Aero Mayflower Transit Company, Indianapolis, Indiana*

Paper: "Internal Control Applications"

R. L. GANTER, *Comptroller, Delco Appliance Division, General Motors Corporation, Rochester, New York*

Paper: "Looking Ahead in Accountancy Education"

JOHN ARCH WHITE, *President, American Accounting Association; Professor of Accounting, University of Texas, Austin, Texas*

INTERNAL CONTROL APPLICATIONS

By

R. L. Ganter

General Motors Corporation,
Rochester, New York

It is a pleasure to return to my Campus and take part in a practical educational program dealing with accounting in the business world.

My subject is a familiar topic with many facets. Before getting into examples, it may be helpful to review some background data on Delco Appliance Division of General Motors Coroporation and a few general ideas on the subject of Internal Control.

Background Information on Delco Appliance Division

Our Division is in the Dayton and Household Appliance and GMC Truck Group. The manufacturing operations of General Motors are made up of six groups, our group and the Car, Body and Assembly, Accessory, Engine and Canadian and Overseas Groups. As a Division of General Motors Corporation, we operate under the Corporation's plan of decentralized policy control. Accounting records and reports are compiled in accordance with corporation accounting practice but considerable latitude is permitted in tailoring each Division's records to conform with local conditions.

Our business at Delco Appliance Division is divided into two broad categories, appliances and electric motors.

1. We produce a complete line of automatic heating equipment and pumps which are distributed nationally by about 3,000 franchised dealers. Our line is presently being expanded to include additional home cooling equipment. We have a nationwide sales organization with sales representatives and regional managers strategically located throughout the United States.
2. Our electric motor business includes automotive motors, split phase motors, series motors and certain defense applications. A separate sales organization handles these products. Automotive applications include heaters, defrosters, window lifts, seat actuators, windshield wipers, antennae lifts and the like.

We have about 35,000 part numbers and 25,000 routing sheets to handle and therefore have a substantial volume of paper work, considering all phases of the business. At the present time, we have 23 productive departments, 39 service and general burden departments and 18 departments classified as Administrative and Commercial, plus a large Engineering Department. We average about 4,000 employees in our two plant locations which are about a mile apart.

General Observations

The background information on Delco Appliance Division will give you an idea of the size and scope of our Internal Control task. Before discussing the tools of Internal Control, I should like to spell out my thoughts on some of the basic factors involved in the use of these tools. Let us begin with a definition of our subject.

Internal Control is the continuing effort exerted by all members of management to accomplish the plans of the business. Internal Control is essential to the success of any business, although by itself, it will not insure success. Many other factors are involved too, such as having a good product or a good sales department.

The success of a business is important to many groups: stockholders, employes, customers, suppliers, the public and the government; therefore, they are interested in varying degrees, either directly or indirectly, in the effectiveness of Internal Control.

The Accountant's part in the satisfaction of the needs of each group has received increasing recognititon. Internal Control, as we are considering it here today, involves the control of the business as a whole. Since all activities of the business carry the dollar sign, the accountant must be concerned with the entire business. The Internal Control job is not his alone, but because he is close to the sources of information, he should be the focal point for many control activities. He is concerned with planning and the future of the business, as well as with critically analyzing day-to-day operations, and these two functions, planning and controlling, are closely interwoven.

Planning and controlling are inseparable, and while plans precede controls, the act of planning in itself is an important form of controlling. This applies to all types of business plans which generally take the final form of a time table, a budget or a forecast. Emphasis should be placed on detailed planning and broad participation in the planning job. Similarly, in controlling results to conform with the plan, wide participation is essential, as the greater the participation, the greater the interest, and the more effective the results. Plans must be realistic and flexible in order to meet changing conditions; they should be attainable with honest effort. They should be kept up to date.

Every department of the business, working together, is responsible for Internal Control. Engineering, Personnel, Purchasing, Production Control, Manufacturing, Inspection, Sales, Service and Accounting are all concerned under the guidance of the chief executive or General Manager. The chief accounting officer has the responsibility of watching the business for conformance to the plans, and assisting each department in its control work.

I wish to emphasize that Internal Control is a group activity. As in all group activities, the basic factor is the individual: his attitudes, abilities, and willingness to work constructively with others to accomplish the objectives of the business. This involves good organization and leadership and an opportunity to do worthwhile things and receive worthwhile rewards. Given the tools of Internal Control, it takes effective and well coordinated supervisory personnel to use them successfully.

Internal Control presupposes an adequate body of records kept accurately, systematically, and consistently by alert, communicative and well-trained personnel.

Planning and its close partner, Internal Control, involve records, analysis, interpretation, communication, decision and action. All are important, but the timely dissemination of facts and the determination of indicated courses of action are dependent upon communication so that all concerned will understand the problem and know the facts upon which to make a decision and take action.

Communication is a cornerstone of Internal Control and there are important techniques which the accountant should keep in mind. Communication is the selling of ideas; it is simple language, arrangement of numbers, charts, explanations, reports, friendliness, forcefulness, timing and many other things. It is salesmanship, and the accountant, to be effective and to make the greatest contribution to the business, must be able to sell the organization so that everyone will help in exercising Internal Control.

The method of communication, i.e., the "Sales Pitch," should fit the personality of the person receiving the information. Timing is extremely important as is the sequence of the data to be communicated. It is better to present data which are 90 per cent complete so that a decision can be made on time than to try and get a 100 per cent complete set of figures and be too late. For good Internal Control it is better to have too little too soon than too much too late.

Preparation beforehand is essential, including an occasional "dry run" as a result of which weakness are often uncovered or conclusions changed. Writing something down often reveals blank spots in your presentation.

The "Cigarette Paper" type of presentation, which is about the ultimate in small size, gets to the meat of a problem quickly, as it forces a careful summarization of the data and saves time for the busy executive with whom you are working. Many of these men are engineers or salesmen, and the data furnished should be in non-technical terms, i.e. plain English.

I overheard a good example of this yesterday. Our mail boy, who had just returned from nearby Oswego, was telling us how cold it was over there. He said the temperature was 50. An engineer, who works on temperature sensing devices, immediately said, "In Fahrenheit or in Centigrade?" Our boy answered "No—No—I just told you it was in Oswego." Moral—Do not be too technical for your audience.

Bookkeeping terms should be avoided. Explanations should be brief and simple because involved explanations are often confusing. Presentations should be positive. They should not be qualified nor should they include red-herrings which raise doubts and lead the recipient into more detail than he needs to make a decision. Presentations should be limited to the matter to be decided, and if more than one matter is involved the most important should be dealt with first. If a decision on one point will automatically provide the basis of working out other problems, the communication or presentation should deal only with the basic problem.

The communicator, who is often the accountant, should be ready with an opinion or recommendation based on the data which has been prepared and carefully studied before being presented. Sometimes verbal communications are better than written ones, while often a combination of the two is the better approach. The story should always "make sense."

If a business is to be profitable and competitive, the Internal Control job is a never-ending one and must be performed energetically every day by every supervisor. To be most effective, all control action should be taken at the lowest practicable management level.

Applications at Delco Appliance Division

The basic factors involved in Internal Control are recognized in our day-to-day applications at Delco Appliance Division. I am going to describe some of the things we do, hoping that a review of a few of our techniques will be helpful to you. We do not think our way is necessarily the best way nor is it the only way, but I do hope what I have to say will stimulate your thinking on this subject.

As a part of General Motors Corporation, our plans and controls are keyed to the needs of the Corporation, which, except for the greater amount of detail required, are our needs.

The information on budgets, forecasts and actual results which we and the other Divisions report to the Central Office is used for a number of purposes by the financial officers, the group Vice Presidents, the President, the various committees and the Board of Directors.

Our discussion today deals with Delco Appliance Division and no attempt is made to relate each of our applications to the overall Corporation program, which is the basis of our system.

Three principal operational plans are used as the basis of our Internal Control Program. These are:

1. Long Range
2. Model Year (or Annual Budget)
3. Four Months' Forecast

All three indicate probable results in advance and thereby provide an opportunity to accomplish desired objectives. Often the need for corrective action in certain areas becomes apparent while the plans (or forecasts) are being prepared and in many instances the matter can be reviewed, a new decision made, and plans changed before they become finalized.

The model year plan, tied in with the annual passenger car model change, is our basic yardstick and it is prepared in great detail, covering each product and line for all price, cost and investment factors. It includes separate budgets for each department of the business.

The four months' forecast, as well as actual results, are measured against the model year budget. The four-months' forecast is prepared monthly to cover the current month and the next three months. This is an important tool as it provides reasonably accurate results for the current month about three weeks before the books are closed. Without such a forecast, management might not know its troubles until it was too late to do anything about them. It not only permits some corrective action in the current month but allows time for changes to the succeeding months. The forecast is prepared in considerable detail, covering all phases of the business. It is a condensed financial statement as well as a statistical and analytical document and is useful to the Corporation for overall planning purposes.

The long-range plan is not as integrated as the other two plans but is essential in order to obtain effective results. In our Division, we have a volume projection by product line which represents our goal at the end of five years. We also prepare quarterly a two-year forecast of tooling and equipment requirements. In order to compile this data, changing requirements for our products in the automotive field and in the home heating and cooling field must be considered. Time tables for new products and new models must be charted. These time tables consider every phase of the job to be done so that the product can be introduced on schedule. Long delivery dates on critical equipment must be considered as well as a multitude of other factors such as capacity, plant layout and manpower requirements.

No effort is being made to cover our entire program with charts. Only a representative coverage is intended. The first shows the form of our two-year capital forecast.

QUARTERLY FORECAST OF FIXED ASSETS
AND SPECIAL TOOLS ON UNAUTHORIZED PROJECTS

1	2	3	4	5	6			
Project No.	Description	Date to Start	Distribution	Estimated Total Expenditure	Forecast by Quarters Qtr.	Qtr.	Qtr.	Estimated Total Expenditure
			Land and Buildings					
			Equipment					
			Tools					
			Total					
			Land and Buildings					
			Equipment					
			Tools					
			Total					
			Land and Buildings					
			Equipment					
			Tools					
			Total					
			Land and Buildings					
			Equipment					
			Tools					
			Total					

This report is prepared each quarter and as pointed out previously, it is an important phase of our long-range planning. Here, as in our entire program, the accent is on the look ahead: information that will help management plan for the future. The data are prepared by the manufacturing organization and approved by the General Manager. As the planning is solidified, information is passed back through the organization so that all groups, Manufacturing, Engineering, Sales and Accounting, can keep in tune. Expenditures are grouped according to purpose and each project is shown separately. The important groupings are: New Models, Capacity Change, New Methods, Integration, New Products, and Replacements.

When funds are requested to accomplish the various programs, a separate appropriation request is prepared and supported by what we call an Economic Justification.

Economic Justification of these proposed expenditures is an important phase of the control program. These studies are important as they get into the whole forward program and require a look at prices, costs, designs, investment utilization and other factors such as market surveys. Sometimes a project is dropped as a result of these studies, and often important changes in plans are required. This can mean design changes, more study on processes and production methods, plant layout, sources of supply, etc. Briefly, the results of such a study are presented in the form as shown on the next chart.

ECONOMIC JUSTIFICATION
OF PROPOSED CAPITAL EXPENDITURE

	Amount
	$
PROPOSED INVESTMENT	
Average Fixed Investment (Capital and Special Tools)	40,000
Additional Working Capital Required	1,000
Total Investment	41,000
TOTAL EXISTING INVESTMENT	500,000
Total Investment Including This Proposal	541,000
COMPUTATION OF RETURN ON INVESTMENT	
Existing Business—Current Operating Profit	75,000
—% Return	15%
This Proposal —Anticipated Net Savings	10,000
—% Return	24%
Effect of this Proposal on Existing Business	
—Anticipated Operating Profit	85,000
—% Return	16%

(Data Fictitious)

Profit resulting from the project is related to added investment and the impact of the project on the product line or total business is also shown. We use Return on Investment as a yardstick, as illustrated. The form we use is a bit different as it also shows the return on investment position after the tools are amortized. This point was omitted from the chart for the sake of brevity.

Another phase of our planning program is shown on the next chart, which will give you an idea of the form of our time table for new products.

This chart indicates an elapsed time of 13 months from the preliminary effort to the volume production stage. A committee composed of the various staff heads closely follows the progress of each project. It helps to establish the target dates and resolves any problems which develop. Without such a time table there could be confusion, losses on initial production and failure to meet dates as promised to our customers with resultant poor customer relations.

NEW PRODUCT PROGRAM

Schedule of Target Dates

PRODUCT DESCRIPTION
APPROVED FOR SUBMISSION TO COMMITTEE DATE

	Phases of Program	Target Date	Responsibility for Action
1.	Preliminary Engineering and Market Appraisal Presented to Committee & Target Dates Established	1- 1-56	Engineering Sales
2.	Experimental Engineering Drawings	2- 1-56	Engineering
2a.	Preliminary Evaluation of Tool Cost, Labor and Selling Price Completed	2- 1-56	Tool Engr. Cost Est.
3.	Model Built and Placed on Test	3- 1-56	Engineering
4.	Test Complete	8- 1-56	Engineering
4a.	Estimate of Tool Cost, labor and Selling Price, Finalized and Appropriation Started	8- 1-56	Tool Engr. Accounting
5.	Underwriters and A.G.A. Approval Obtained	10- 1-56	Engineering
6.	Production Drawings Issued	10-15-56	Engineering
6a.	Appropriation Approved	10-15-56	Accounting
7.	Tools Available in Plant	12-15-56	Tool Engr. Purchasing
8.	Material Available in Plant		Prod. Control
9.	Tools Tried Out, Altered and O'K for Production	12-15-56-1/15/57 12-30-56	Purchasing Tool Engr.
10.	Pilot Run Production in Quantity 100	1-15-57	Tool Engr. Manufacturing
11.	Units Produced in Volume	2- 1-57	Manufacturing

(Data Fictitious)

NOTE: The letter (a) indicates concurrent action.

The foregoing charts illustrate several phases of our long-range planning program, and now let us move on to our Model Year budget which was already mentioned briefly.

Each year we estimate for the coming year our sales in units and dollars, our costs in detail, our profits, our capital requirements and our return on investment, etc. This includes the cost of rearranging a department; it includes the estimates of sales potential and distribution costs. Time studies are made, burden rates derived from the manufacturing people and so on throughout the whole organization. Each department sets its own goals, subject to the General Manager's approval. The budget program has his support and the support of all the Staff heads.

Once the Divisional budget is prepared, it is subject to further review and approval by the Central Office operating executives on the basis of a review by the Central Office Comptroller's Staff.

The next two charts illustrate the form of the budget summaries. They have been simplified for the sake of clarity.

1956 MODEL YEAR PROFIT AND LOSS BUDGET

	Total Division	Product Line
Net Sales		
Factory Cost of Sales		
Factory Profit		
% to Net Sales		
Factory Cost Adjustments		
Commercial Expense		
% to Net Sales		
Other Income or Deductions		
Operating Profit		
% to Net Sales		
Add: Fixed & Non-Variable Expense		
Variable Profit		
% to Net Sales		
Breakeven Net Sales		
Total Net Investment		
% Return		

The budget is a complete income statement and is consolidated for the Corporation. It includes sales by product line. It shows the break-even point expressed in terms of annual sales volume. In these budgets, fixed and non-variable expenses are treated separately from variable expense so that the figures can be readily adjusted for volume changes at any time during the year. On our official form, the commercial expenses are detailed by account for administration, sales, advertising, and so on.

This next chart is a summary of cost, investment and fixed and non-variable expenses. Cost is shown in complete detail. Investment data are shown, detailed by product line and for representative models. Working capital is segregated between cash, inventories, and so forth. Fixed and non-variable expenses are analyzed. The amounts detailed on this form are shown in total on the first slide covering sales, profit breakeven and return on investment data.

These summaries are supported in great detail, in a manner closely paralleling our actual accounting records, thus enabling a multitude of comparisons.

The annual or Model Year budget is our par for the coming year, and every member of management has the approved budget standards, applicable to his operation, for use at all times. We compare actual results attained with these budget standards, adjusted to the actual volume realized. This is done continually and provides overall data for our General Manager as well as data for each Staff Head—Sales Performance for the Sales Manager, Cost Performance for the Manufacturing Group and so on.

1956 Model Year Profit and Loss Budget

	Total Division	Product Line
Analysis of Factory Cost of Sales		
Material and Freight		
Labor		
Burden - Variable		
- Non-Variable and Fixed		
Tools		
Engineering		
Overtime, Night Shift Premiums, etc.		
Total Factory Cost of Sales		
Analysis of Total Investment		
Gross Plant		
Less: Depreciation Reserves		
Net Plant		
Deferred Special Tools		
Cash		
Receivables		
Inventory		
Total Net Investment		
Fixed and Non-Variable Expense		
Manufacturing Expense		
Special Tools		
Engineering		
Commercial Expense		
Other		
Total Fixed & Non-Variable Expense		

Ideas are sometimes deflated by the information we develop. When this happens to our sales manager, who incidentally is an Ohio Stater, he calls us head shrinkers.

Adequate control is almost entirely dependent on the current day-to-day comparison of these budget standards against the actual performance. Because of this, we stress this type of comparative analysis. Our operating people are trained in the proper use of these standards, and this type of control is effective because they understand the necessity of striving constantly to meet or better their budget standards.

In addition to the annual budget, we also plan ahead for the near term by means of monthly forecasts. These forecasts are made each month for four months ahead, and they supply complete financial data. Each month, therefore, is forecasted four times. The forecasts present a shifting picture in line with the constantly changing nature of our business. They are vitally important as they tell us where we are going before we get there.

Several of the forecast schedules closely parallel the ones shown to illustrate the Model Year budget summaries. We have several others to show you, each of which illustrates a type of report we find useful in our business. These charts are in simplified form.

The first forecast chart shows sales and factory profit by product line changes in methods and assist in evaluating them. The purchasing people review material costs and commitments for price or source changes, etc. Based on the schedules planned for the forecast period, each general fore-for the next four months in comparison with the actual results for the previous month. In order to develop these figures, our process people forecast

MONTHLY FORECAST OF SALES AND PROFITS
BY MAJOR PRODUCT OR CLASSIEICATION

Major Products or Major Product Classifications	Net Sales					Factory Profit				
	Actual Previous Month	Forecast by Months 1	2	3	4	Actual Previous Month	Forecast by Months 1	2	3	4
Automotive Motors										
Windshield Wipers										
Automatic Heating Equipment										
Other Commercial										
Defense										
Total										

man and department head forecasts his anticipated costs. The thinking of the entire organization is reflected in this schedule. Incidentally, the detailed estimates as to material, labor, burden and other costs are punched into tabulating cards which are then used in analyzing variances from the Model Year budget standards, which are in a master deck of cards. The detailed planning which goes into the forecast preparation results in a general awareness of the areas requiring attention and control.

The next chart points up the production, sales, inventory problem, and provides the all-important look ahead in this area. This shows the beginning and ending inventory position by month for each product line. One of the major Internal Control problems facing any business is the determination of production schedules and sales forecasts. We can check our customer commitments against Corporation schedules on the automotive portion of our business.

FORECAST OF UNIT PRODUCTION, SALES AND INVENTORY

		Product Line A	B	C
Stock at Beginning of Forecast Period		1,000	1,500	2,000
FORECAST PRODUCTION:	1st month	800	1,000	2,000
	2nd month	1,000	700	2,000
	3rd month	1,400	700	2,000
	4th month	800	600	2,000
4 Months Forecast Production		4,000	3,000	8,000
FORECAST SALES:	1st month	700	500	1,500
	2nd month	900	500	1,800
	3rd month	1,500	500	2,200
	4th month	900	500	1,500
4 Months Forecast Sales		4,000	2,000	7,000
STOCK AT END OF FORECAST PERIOD:	1st month	1,100	2,000	2,500
	2nd month	1,200	2,200	2,700
	3rd month	1,100	2,400	2,500
	4th month	1,000	2,500	3,000

(Data Fictitious)

In addition, our appliance fieldmen are close enough to the market to furnish reliable data which our market research group reviews in the light of historical seasonal trends. The determination of the production and sales forecasts is a basic operation as all of the other estimates stem from these figures. Production Control, Sales Manufacturing, Accounting and other personnel are involved in these volume estimates.

When these data are established and approved by the General Manager, they are mark sensed with a graphite pencil on our tabulating decks and extended to compute departmental manpower loads, material usage, etc. The extensions of standard labor and burden are supplied to all department heads for their use in forecasting their operations for the next four months.

The next chart will illustrate the departmental forecasts of labor and burden which we have been discussing. The forecast is limited to departmental items and such expenses as heat. Light and power are estimated separately by the Plant Engineer; Employee Benefits, Taxes and Insurance are estimated by the Accounting Department, as are fixed charges for depreciation, etc.

DEPARTMENT FORECAST LABOR AND BURDEN

Press Room		Actual Previous Month	Forecast Months 1	2	3	4
		$	$	$	$	$
Direct Labor	—Budget	1,000	1,050	1,100	1,000	800
	—Actual	1,020	1,060	1,100	990	810
	—Variance	20	10	--	10	10
Indirect Labor	—Budget	805	835	865	805	685
	—Actual	782	790	795	790	750
	—Variance	23	45	70	15	65
Supplies & Tools	—Budget	154	162	170	154	122
	—Actual	142	180	165	170	110
	—Variance	12	18	5	16	12
Maintenance and Rearrangement	—Budget	100	102	104	100	92
	—Actual	140	130	80	25	110
	—Variance	40	28	24	75	18
Losses Errors, Etc.	—Budget	63	66	69	63	51
	—Actual	84	80	75	60	51
	—Variance	21	14	6	3	--

(Data Fictitious)

The budgeted labor amounts are supplied to each department head along with the budgeted expense amounts. Since our Model Year budget breaks down all cost elements into fixed and non-variable items and variable cost items, it is easy to calculate expense allowances at any labor volume. In this example, with a labor volume of $800.00 in the fourth forecast month, the indirect labor allowance drops to $685.00 and so on.

Forecasts are prepared by the department heads on a realistic basis. If important variances from the Model Year budget standards are indicated, the variance is either justified or the forecast is changed. The estimates are then summarized for the entire Division and further reviewed by the General Manager. Similar forecasts are prepared for each item of Commercial and Engineering expense by each department head. Since close follow-up is essential we watch our labor and burden performance on a daily basis. We have our labor standards for each product in a deck of tabulating cards with information for each work group in each department. Production counts are furnished to the time keeping department early each morning and the quantities are marked sensed on the tabulating cards. The tabulating department prints a list showing production counts, unit standards and extensions for each part number, by group within each department for the previous day.

Along with this, our daily time distribution is prepared and any charges for down time are checked against the labor distribution control chart. This chart states the conditions under which the time of productive labor operators may be charged to expense accounts. The Time Study Department approves these "charge-offs" on a current basis.

Each day, an efficiency report is issued to each manufacturing supervisor for the previous day. The next chart illustrates this report. Standard and actual hours and daily and cumulative (for the week) efficiencies are shown, together with appropriate remarks where important variances are indicated.

This type of report is a "Basic" one as it is prepared primarily for first line management, the foreman, who is responsible for the control of a large part of our costs, particularly labor and burden. In evaluating the performance of a foreman, we recognize that he is not solely responsible. He has the primary responsibility for eliminating those conditions impairing the normal productive effort of his operators, but this requires a *cooperative attitude* throughout the organization and *aggressive action* on the part of other departments in performing their functions, which affect the efficiency of a productive department.

For example, the Inspection Department must furnish accurate counts of parts produced; the Standards men must establish good standards, work with the foremen in attaining them and assist on manpower planning; the Sales Department is responsible for good forecasts on which schedules are based; the Production Control Department must have the materials available and work out balanced schedules; the Tool

DAILY EFFICIENCY REPORT

DEPT. Press Room DATE 3/17/

GROUP	HOURS		EFFICIENCY		REMARKS
	Standard	Actual	Daily	To Date	
601	145	150	97%	96%	
602	56	75	75%	70%	Faulty material
					—Follow up
					with Purchasing
612	80	80	100%	99%	
Total Dept.	530	550	96%	96%	

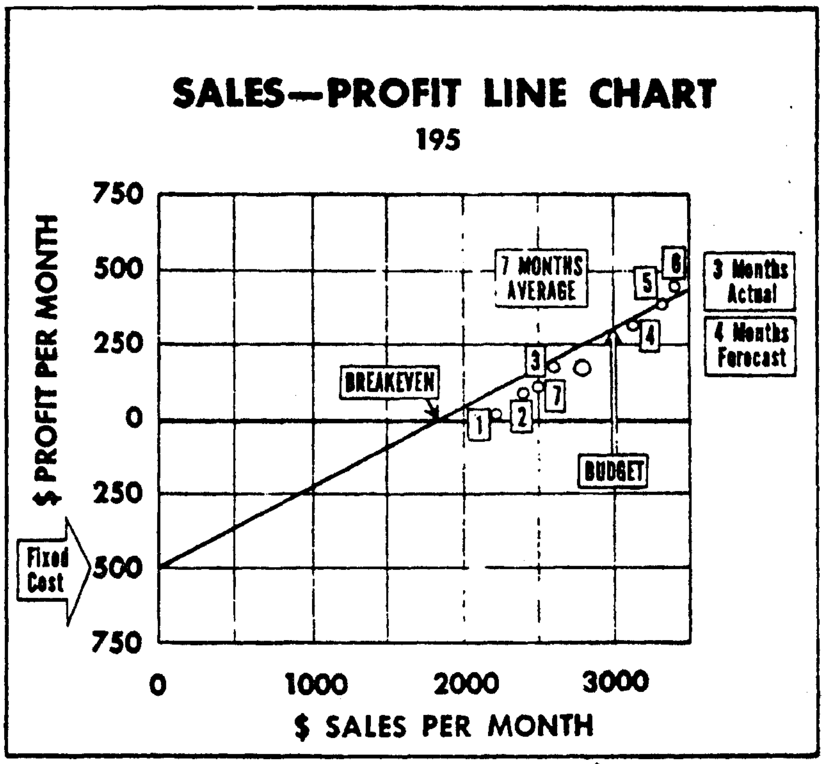
(DATA ARE FICTITIOUS)

and Process people must assist in their area. The Engineering Department, Personnel Department, Accounting Department and others are also involved as designs and lead time, capable people and adequate records and reports all play a part in the question of efficiency.

The degree of success attained in getting effective cooperation from all departments and in maintaining a steady flow of accepted production out of each work group is reflected in this report.

We have a similar report on burden, or manufacturing expense, which is prepared to help in the control of this important cost element. We call this our Daily Plant Report as illustrated on the next chart.

This report shows the budget allowance, the actual expense and the variance for the day and month to date for a department, broken down by major classification. The budget figures have been adjusted to the actual volume level and therefore exclude any variance due to volume fluctuations. The variance, therefore, is chiefly attributable to efficiency or lack of efficiency. Supplemental analyses are furnished whenever the condition demands it and when it is of importance to management. The scrap accounts are analyzed very closely on a day-to-day basis.



(DATA ARE FICTITIOUS)

It may surprise you to know that we do this job daily, but here again close control is essential. While obviously not all of the data can be obtained on a 100 per cent accurate basis each day, a surprising amount of it is available through our system. We issue similar monthly and semi-monthly reports on the various commercial expense items by department and by project for engineering expenses. The two previous charts illustrate our approach to labor and burden control in the plant. In order to relate performance to the cost-price picture we compare unit costs with the budget standards. The chart shows this comparison. This report tells us where costs vary from the budget, by how much and where we should focus our attention.

DAILY PLANT REPORT

DEPT. ASSEMBLY **DATE** 3/17/

	TODAY			MONTH TO DATE SAVINGS
	ORIGINAL BUDGET	ACTUAL	SAVING	
Indirect Labor	$ 396	$ 416	- $20	- $210
Supplies & Tools	341	333	8	84
Heat, Light, Power	144	154	- 10	- 105
Maintenance & Rearrange.	228	240	- 12	- 126
Employe Benefits, Taxes, Etc.	188	198	- 10	- 105
Losses, Errors, Etc.	39	38	1	11
Fixed Charges	158	156	2	21
Total—Burden	$1,494	$1,535	- $41	-$430

(DATA ARE FICTITIOUS)

Material cost receives a great deal of attention; the engineers try to design cost out of the job providing they can do so without impairing quality. The purchasing people buy as advantageously as possibile through competitive bidding and the development of new sources. The responsibility for the efficient *use* of material is, of course, in the shop. Standards of usage are established and those responsible are held accountable for meeting these standards. The Cost Department analyzes significant material cost variances by part number and/or raw material and submits reports to the various members of management.

As previously pointed out, we compare both actual and forecast data to the Model Year budget. Several charts will illustrate these comparisons.

One of our best known charts is our Sales-Profit Line Chart. This shows on a monthly basis the outlook budget line; it shows the break-even point and includes both actual results and the forecast picture for the next four months. Where the dots representing each month are below the line, results are not favorable, and when above the line the performance is better than budgeted.

In this example the sales and profits are below the budget level for the three actual months while the fourth, fifth and sixth month exceed the budget sales level and are about on the profit line. The seventh month reflects a drop in sales, perhaps due to inventory shut down. The simplicity of this chart is probably its most important feature because a glance will show results as compared with the budget.

UNIT COST SUMMARY
February, 195

	ORIGINAL BUDGET	ACTUAL	
		January	February
	$	$	$
SELLING PRICE	14.00	14.00	14.00
FACTORY COST			
Material	4.20	4.19	4.22
Labor	2.15	2.20	2.18
Burden.	4.25	4.35	4.30
Other	1.10	1.19	1.15
TOTAL FACTORY COST	11.70	11.93	11.85
FACTORY PROFIT.	2.30	2.07	2.15
% PROFIT TO SALE. . .	16.4%	14.8%	15.4%

(DATA ARE FICTITIOUS)

The next chart furnishes a quick look at the return on investment picture. In this example, you will see a model year to date picture made up of several months' actual results plus a four months' forecast. The data are fictitious, of course, as in all of the previous charts.

The impact of volume change is shown to arrive at the budget figures at actual volume for both profit and investment factors, and the variances are reflected in terms of their impact on the return on investment rate. In this example the indicated return for the actual plus the forecast period is 18.3 per cent or 1.7 points below the budget. This is made up of a gain of 3.9 points resulting from the higher volume level, with its impact on fixed costs and fixed investment, 3.8 points of loss due to unfavorable profit performance and 1.8 points of loss due to unfavorable investment performance.

The variances for profit are analyzed to indicate the reasons and the amounts for each item of variance, such as material cost, direct labor, expense, product mix, and similarly for variances in investment, by element. In preparing the forecast, the estimated actual data and the corresponding budget data are processed in the tabulating department and the variance amounts are automatically provided with the forecast amounts.

RETURN ON INVESTMENT ANALYSIS

	Budget	Volume Change	Budget at Forecast Volume	Profit and Investment Variances Amount	Profit and Investment Variances % Return Effect	Actual and Forecast Volume
	$	$	$	$	%	$
PROFIT AND LOSS						
Total Sales	20,000	2,000	22,000	xx	xx	22,000
Factory Profit—Amount	3,600	360	3,960	260	2.5%	3,700
—% to Sales	18.0%	18.0%	18.0%	1.2%	xx	16.8%
Factory Cost Adjustments, etc.	100	240	340	10	xx	350
Commercial Expense	1,700	100	1,800	150	1.3%	1,950
Operating Profit—Amount	2,000	500	2,500	400	3.8%	2,100
—% to Sales	10.0%	25.0%	11.4%	1.9%	xx	9.5%
Fixed and Non-Variable Expenses	3,000	xx	3,000	xx	xx	xx
Variable Profit—Amount	5,000	500	5,500	xx	xx	xx
—% to Sales	25.0%	25.0%	25.0%	xx	xx	xx
INVESTMENT						
Net Plant	4,700	xx	4,700	300	.5%	5,000
Tools	800	xx	800	xx	xx	800
Cash	1,000	100	1,100	xx	xx	1,100
Receivables	1,000	100	1,100	600	1.0%	1,700
Inventory	2,500	250	2,750	150	.3%	2,900
Total Net Investment	10,000	450	10,450	1,050	1.8%	11,500
% Return on Investment	20.0%	3.9%	23.9%	xx	5.6%	18.3%

(Data Fictitious)

We feel that Return on Investment is a good common denominator, an ideal measuring stick in that it not only measures profit performance but also measures how efficiently capital is being used. It shows how well we are controlling inventories, collecting our receivables, and so on. The value of the measuring stick is increased when "Par" is shown in the form of the annual Model Year budget rate of return.

There are many other tools at our disposal, and we try to use them all. Good procedures are particularly important in the Internal Control job even though we have not discussed them to any extent today. The charts presented illustrate our approach without getting into the many subsidiary reports which are needed in daily operations.

We try to "boil down" the various reports so that their essence can be presented quickly either verbally or in written form. This permits an opportunity to tailor the information to the needs and personality of the recipient. An effort is made to give each responsible person the information he needs to control his activity. In order to provide timely, continuous assistance to the entire organization, we have a separate department called the Analysis Section to correlate budgets, forecasts, reports and other economic studies related to Internal Controls. This section does considerable interpretive work and strives to present the facts in non-technical form.

We feel that Internal Control is a plant-wide job at Delco Appliance Division, and we in the Accounting Department try to help the entire supervisory force accomplish their objectives.

LOOKING AHEAD IN ACCOUNTANCY EDUCATION

By

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Current Balance Sheet of Accountancy Education. Sachel Page confounded the experts in baseball by continuing to be an effective pitcher until he was at least 50 years old. When asked about the reasons for this anomaly, Sachel replied, "Don't never look back; some 'un might be gaining on you."

In spite of Sachel's advice, we must look back in education to discover our mistakes if we are to correct them. It should be helpful to our discussion today to take a quick look at the present situation in accountancy education. A brief balance sheet of our strength and accomplishments arrayed against our weakness and failures would include the following:

On the asset side we can list:

1. The solid growth and development of schools of business spearheaded by the development of education in accounting.
2. The achievement of academic respectability for collegiate education in accounting and business, a long-sought recognition from colleagues in other disciplines.
3. The increased prestige of accounting education in the eyes of business and public accountancy. This is evidenced by many expressions such as the increased recruiting efforts directed towards our graduates, use of college teachers as consultants by business, co-operation in faculty residencies, outright grants of financial assistance scholarships, fellowships, etc.
4. The successes attained by many of our graduates, who, perhaps in kindness, permit us to attribute these successes at least in part to their earlier training in college.

These abstract and for the most part immeasurable strengths and accomplishments may appear to be more than offset by our failures. Let us look at the liability side of the balance sheet. These weaknesses and failures seem apparent:

1. There is unquestionably wide variation in the quality of educational standards among our colleges today. This wide variation is particularly revealed by the results of the Achievement Tests developed by the American Institute of Accountants and given annually to students of accounting in many of our colleges across the continent. For example, the results of the 1950 tests (Level II) given to 2,500 seniors from 86 colleges in 1950 showed very discouraging variations in quality. Not a single student from the lowest eight schools made as high a score as the median student in the group from the eight highest schools.*
2. There is a general failure to produce a graduate with well-rounded education, one who possesses that "common core of knowledge that should be in the firm and quiet possession of every person who lays claim to a liberal education."
3. There is a general failure to build teaching staffs in accounting adequate for the job and even equivalent to those in some of the older branches of collegiate instruction.
4. There is a failure to attract a fair share of the better high school graduates to collegiate education in accountancy. Actually we appear to be losing ground here steadily. This is in part due to the increased competition within the schools of business for the interest of our better students.

Obviously, this is only a partial balance sheet of accountancy education. I shall leave you the task of striking the balance of current net worth.

Storm Signals on Education's Horizon. There has been a general awakening in education in recent months, and particularly in business administration and accounting. What are the storm signals that brought on our immediate alarm? Here are some of them:

1. Mounting enrollments are bringing acute staff problems in accountancy education. And the future is actually alarming in this respect.
2. This acuteness in teaching supply, some feel, is already beginning to lower the quality of accountancy education; and this deleterious effect will become more noticeable within the next 10 years unless remedies are found.
3. Studies indicate that the "economic position of teachers of business administration, measured in terms of the purchasing power

* Students Department, *Journal of Accountancy,* May 1951, p. 763.

of the dollar has declined relatively and absolutely during the last 15 years."*

Does this indicate further deterioration of standards already weighed in the balance and found wanting?

4. Continued demands come with increasing frequency from public accounting and industry for improvement in the accounting graduate.

What to Expect in the Future? The exigencies of the present situation, the expected strain on faculties and facilities of the next 10 to 15 years, and the apparent absence of alternatives lead to certain conclusions as to future developments in accounting education. As a minimum, I feel we can expect the following future developments:

1. An increase in the stature of education in the profession and a concomitant increase in the stature of accountancy in our economic and social cosmos.
2. An increase in the demand for the "educated," well informed, cultured accounting graduate.
3. An increase in professional (technical) training, not less.
4. A substantial change in teaching methods and procedures with somewhat less reliance on the lecture system.**
5. A broadening of our concepts of the university teacher with the probable recognition that some who do not publish may nevertheless be valuable adjuncts to the scholar, researcher and writer.

As the profession of accountancy grows up, education must assume a leading roll if the prestige of the profession is to reach the height to which we aspire. But education must earn that leading roll.

I wonder if the professions are not ranked now in the public's regard as to proficiency and professional excellence in proportion to their education requirements. The medical profession surely is ranked near the top. Every state requires graduation from medical school as a prerequisite to practice of medicine. Law is well regarded. In 48 states plus the District of Columbia some college training is a prerequisite to sitting for the bar examination. And 16 states require a law degree.

The profession of public accountancy is making very slow progress

* Arden House, Conference, October 27-29, 1955, on Professional Education for Business: "Faculty Requirements and Standards."

** Henry Steele Commager, Columbia University history professor: "One reason for our current difficulties is that we are, in a sense, the prisoners of our own traditions and habits, and particularly the prisoners of one tradition, the tradition of the lecture." (New York *Times* Magazine, 1/29/56) in this direction. Forty states still have as minimum educational requirement only a high school education or its equivalent. True, this profession is still young. Yet more progress in raising educational requirements should be expected of such a vigorous profession. It is encouraging at the present time, however, to hear the leaders in public accountancy express firm support for increased educational requirements.

We must look forward to more improvement here.

In spite of the lowest educational requirements of any of the professions, the loudest voice heard at the present time demands "a well-informed, cultured" individual for accountancy. Donald H. Perry in his Dickinson Lectures states that "Professional education must have the aim of training leaders . . . Social, cultural, and intellecual acceptability enhances the accountant's influence and usefulness, broadens his human relationships, and better fits him to understand and carry out the social aims of his profession."* Have we as accounting educators done much except give lip-service to this recognized demand? I think we will in the future.

The justifiable clamor for more "liberal education" for the accounting graduate has occasioned much "fuzzy" thinking and many hasty conclusions within our rank. If more "liberal" education is good, *per se* less technical education is necessary. So runs the conclusion too often made. Of course practical limitations of time have influenced our thinking here. We now have only a "four-year pie" to divide among liberal studies, general business studies, and accounting studies. Many feel that we must increase the size of the pie if any of the slices are to be increased. At the moment the five-year program seems to be the logical answer. Certainly, longer periods of attention to "implant the common core" of education are needed. But with the increase in the type of service rendered by the accountant, with the impending electronic revolution in accounting and industry, technical training must not be decreased. It should be increased. If the rewards are great enough, the time of preparation can be materially extended without turning away the competent students.

Maybe even five years are not enough. Perhaps, we here shall see professional schools of accountancy require three years of college training or even a bachelor's degree as pre-requisite to admission. Accountancy *is* the only established profession without a separate school. Even if the separate school failed to produce better educational training, I am not

* Perry, Donald H., *Public Accounting Practice and Accounting Education*, Graduate School of Business Administration, Harvard University, p. 53.

sure but that it would result in considerable increase in prestige for accountancy.

Attacking Our Problems. Most of us have thought of ways of attacking our problems. I should like to list and then briefly discuss a few of these.

1. Give more attention to selection of students for accounting majors.
2. Improve the selection and training of teaching staff.
3. Seek means of better utilization of teaching staff.
4. Improve utilization of facilities.
5. Clarify our objectives and keep them ever before us.

Selection of Students. Considerable effort is now being made to acquaint the high school graduate and the lower division college student with the opportunities offered by the professional career in accounting. You are acquainted with the films and the career pamphlets published by the American Institute of Accountants. Some work has been done by other accounting organizations. Understandably the efforts of the American Institute have been directed toward acquainting the young people and their advisors with the opportunities offered in public accounting. The AAA has been working on the broader aspects of the problem for several years. Our Committee on Student Personnel has prepared a tentative draft of a pamphlet entitled "Shall I be an Accountant?" This committee seeks to describe the opportunities of the whole profession —commercial and industrial accounting as well as public accounting. I have read this tentative draft and believe that it will become an excellent vehicle for the purpose, if it can be widely distributed.

Informing the high school graduate and other potential accounting students of the nature of and the opportunities offered by accountancy is important but must be complemented by a better job of selection. Only the fit can help build the profession and only the fit should be admitted. This task must rest more and more on education. Selection by survival of the fittest after employment is wasteful and unsatisfactory in more ways than one. Perhaps proper utilization of the American Institute's Orientation Test would help. Other aptitude tests are also available and others could and would be prepared if we became seriously interested. Serious counseling should be our concern in the future.

Some better efforts at selection through higher grade standards for the accounting graduate needs wider exploration by educational institutions.

Then, too, there is obviously a leak in the pipe line between high school and college. We are losing too many of the better high school graduates, who for one reason or another do not go to college. Dr. John C. Perkins, President of the University of Delaware, states that only one-half of the better high school graduates ever go to college.* He shows that the broadening of the high schools community responsibilities and the introduction of terminal courses for those not going to college has tended to change almost completely the high schools' traditional function as college preparatory schools.

This has almost certainly resulted in diverting large numbers of high school students with capacity into terminal programs. Generally, the most intelligent also succeed best in auto mechanics, bookkeeping, and other vocational arts. Upon graduation from high school, these better students are attracted by good salary offers and are thereby diverted from collegiate training without serious counseling by the schools and education of parents on this problem. Thus much needed brain power is lost to our nation at a time it is needed most.

Don Perry advances the idea of an early selection and early preliminary training of secondary school students for careers in the profession.** I feel that there are great possibilities in this idea. Why not establish a "pool" of students in early high school who appear to have aptitude and interest in professional careers and begin immediately to train for professional leadership? This would be possible in the larger high schools. It would greatly lengthen the training period and give more significance to the educational program for these students. (I would envision no accounting or business training for this high school "pool.")

We hear voices raised in nearly all the professions for a better informed, more liberally educated graduate. Recently *Time* Magazine (February 13, 1956) reports Dean William Warren of the Columbia University Law School as saying:

> "We are entitled," he wrote, "to expect that the college graduate be able to read argumentative or expository prose swiftly, comprehendingly, and retentively; that he be able to express himself in speech and writing gramatically, literally, and precisely; that he has learned the basic lesson of using a dictionary. But we have found that few of our entering students, however, carefully selected, possess these skills to the extent needed for law study.
>
> "What is scarcely less disturbing is that there is in this group no common core of knowledge that should be in the firm and quiet

* Perkins, John C., "What Are Our High Schools For," ***Saturday Evening Post,*** March 24, 1956.

** Op. cit., p. 54.

possession of every person who lays claim to a liberal education . . . a knowledge of American history, of American Government, and of the structure and working of our economy.

"Any encouragement one might derive from the robust percentages of these students who had received training in writing is shattered when one actually encounters in mass the written work of law students. Even the most tolerant of the critics will concede that whatever be the arts of which the students are bachelors, writing is not one of them."

Apparently the "common core" in education is about the same for all the professions. The high school could start implanting the "common core" for all selected for professional careers. Then we should continue this phase of the education of the well-rounded professional throughout the whole of his college career, from freshman year through senior year. The one-shot exposure now generally given in college during the first two years is not taking.

Teaching Staff of the Future. The chief difficulties in our way now in securing and keeping outstanding young men on our teaching staffs are lack of long-range financial prospects and present poor working conditions. Frankly, the latter is one of the hidden risks of sending our young staff members out in the summer and at other times to secure experience. They see the fine equipment, adequate office space, good secretarial and other help in business and become less satisfied with working conditions in the universities. What a contrast to the facilities available on the campus! In spite of the risk of losing these young men (we do lose many), I believe we should still continue to take every advantage of these opportunities to secure practical experience.

The long-range financial prospects are even more discouraging. Here things are apparently getting no better. A study by Beardsley Ruml and Sidney G. Ticktton reported "drastic deterioration" in the compensation of the top professors. "In 1891, The University of Chicago established a rate of $7,000 probably the highest in the country. Today's equivalent would be $38,300. In 1908, top professional salaries of $5,000 were not uncommon. Today's equivalent, merely to restore the 1908 status, would be $19,200."* Apparently, there is little deterioration in the first and middle brackets. But high possible salary ceilings might well provide adequate incentive to attract many more capable young scholars to the university classroom. This is the conclusion reached by the Com-

* Ruml, Beardsley and Tickton, Sidney G., *Teaching Salaries Then and Now*, The Fund for Advancement of Education, Bulletin No. 1, (1955).

mittee of Fifteen which said: "Additional recruitment (of teaching staff) is not possible without restoration of the economic and professional status of teachers."** By restoration of professional status the Committee means professional recognition for teaching performance well executed so that the teacher will know full well that he has approval for the contribution he is making. The Committee states:

> "The fact that many institutions fail to reward superior teaching by professional recognition lowers the teachers' prestige and draws away from teaching some who are better at teaching than at research or administration, but who feel conscientiously obliged to seek the rewards of the better paid occupations."

In the past the *sine qua non* for advancement and recognition in college teaching has been writing and research. Many college administrations and many members of the college faculties "hold teachers in lower regard than publication." Both, good teaching and research and publication, are, of course, essential to the fulfillment of the university function. Good teaching without the vitalizing effect of research is, in my opinion, impossible for sustained periods. Vitalized teaching can and does exist without publication. I know some excellent teachers who spend many hours searching for new materials, designing interesting and effective means of presentation, and seeking to stay abreast of current developments in business and practice. And although I deplore the loss felt when these fail to pass their findings, I take my hat off to the job they do in the classroom. The obvious conclusions seem to be recognition of at least two kinds of staff members in accountancy education, viz.

1. Scholar, researcher, writer, who perhaps does less teaching than his colleague in the collateral position.
2. Teacher and researcher, primarily engaged in teaching and in advancing his knowledge of the teaching area and in perfecting his method of presentation.

Neither of these should outrank the other *per se;* recognition should be proportionate to achievement.

Note that research is an indispensable tool of both types of staff members. Without it the scholar-writer cannot function; without it the teaching of the teacher becomes sterile and ineffective. We need both of these types of staff members. And by recognizing the equal importance of the teacher-researcher, I believe we will gain many valuable additions to staff from professionally competent individuals who cannot and will not publish.

** Strothmann, F. W. on behalf of the Committee of Fifteen, "The Graduate School Today and Tomorrow," Fund for the Advancement of Education.

Professor Strothmann's Committee goes on to recommend a professional degree for college teachers, pointing out that the PhD, as such, is not primarily a "teaching degree." Or, the Committee says, the PhD program

> "should be broadened in such a way that genuinely creative scholarship, not mere fact-grabbing is to be demanded of each candidate *qua* scholar; that professional competence in teaching is to be expected of each candidate *qua* teacher; so that the ultimate choice of such a scholar-teacher between research and teaching will be determined neither by inability to teach nor by incompetence as a creative scholar."*

Better Utilization of Teaching Staff. One way of attacking our problem of inadequate teacher supply is better utilization of the teaching staff. I should like to express my own ideas as to some of the ways by which I believe this might be done.

Carefully appraise each staff member as to his special abilities and then confront him with the teaching assignment best suited to those abilities. Typically, we operate on the principle that each professor should teach the same member of approximately the same size classes. This appears to be an absurd conclusion. I must agree with Tom Carroll that the contributions of the really great teacher should not be curtailed by limiting his influences and teaching efforts to three classes averaging 30 students each.** Of course, all great teachers may not be effective when teaching large groups. In this case, they should be assigned to smaller classes. Probably most college teachers should be assigned to teach small groups. And this does not in any way deprecate their abilities and contributions to the teaching function. Again all cannot and should not be expected to fit into the same mold.

Another way towards better utilization of the teaching staff is to provide more assistance to the college teacher for the performance of routine and clerical tasks, thus freeing him for greater contributions in the classroom. How long would an industrial concern permit a $10,000 a year man to spend up to one-third of his time pecking out notes and other material on the typewriter, running errands to the library, filling out reports, and performing other minor tasks which any $300 a month secretary or assistant could do? Yet, in my observation, this situation is typical for the college professor.

* Strothmann, F. W., *op. cit.*

** Carroll, Thomas H., "Attracting and Maintaining a Supply of Effective Accounting Teachers," *The Accounting Review,* January, 1956.

Recently we had a management survey made at our institution. I have not yet learned the detailed recommendation made. I am anxious to know if mention was made in the report of this obvious waste. I firmly believe that if adequate research assistance and stenographic help were given each professor, he could increase his teaching load by one-fourth to one-third and not feel overburdened thereby. Please understand that I am describing what I believe to be the typical situation of the college professor in these respects. I realize that some institutions are much more liberal than others in furnishing aid other than grading assistance.

Use of Better Facilities. Both the production and the quality of accountancy education can be improved by the increased use of visual aids and other devices and channels for education. Many of us were awakened somewhat to the possibilities of the use of mechanical visual equipment by returning servicemen, who reported on the successes our armed forces had with these devices during an emergency that demanded training of masses, and training completely adequate to meet a desperate need.

During the current year, I have been experimenting with the vugraph in teaching a large class in principles. This class has approximately 125 members. I have been amazed by the aids rendered by this machine. So far, it appears that those in this large section are doing just as well as students taught in sections of 40. Many other effective visual aids might well help our situation. Of course, aids used in one course might well be unsatisfactory in another course.

Pennsylvania State University is experimenting with closed-circuit television in instruction. One of the instructors handling classes in principles wrote me as follows:

> It is not believed that TV classes are better than small sized classes (30 students) taught by good teachers. But with the shortage of good teachers it is believed that several classes taught by one good teacher on TV is a better situation than the same teacher teaching all of the students in one big room—especially true for courses like accounting. Also this is superior to small individual classes with most of them being taught by teachers with little or no experience.

The University of Houston is experimenting with instruction in principles on regular scheduled TV programs. A limited number of resident students are permitted to register for the course. These students are given prepared manuals in which to take notes. They then report to assigned laboratories for supervised work. Early reports from this institution indicate greater success with this medium than thought possible.

Certainly, I see no immediate possibilities of this kind of impersonal instruction being utilized in very many teaching situations. Yet, I applaud these pioneering institutions for their initiative and resourcefulness.

These experiments are indicative of the educational alertness we can expect in the future. Convention will not be preserved either for tradition's sake or because of lethargy in administration of our institutions of higher learning. And it is through such experimentation that we may find some of our answers.

Keep Our Educational Objectives Ever Before Us. We do need to clarify our objectives in the education of the accounting student. And we need to review these objectives periodically; discuss them often; revise them when necessary.

I should like to name a few objectives which I believe fundamental. Implant the "Common Core." See that our graduates are well informed, literate, and articulate. Train them for first-class citizenship. Increase our standards for technical know-how. These objectives have already been treated briefly.

Finally, we must teach our graduates to think. I fear this is one of our greatest failures now. Too much insistence on formula and form will choke out the budding power of conception and rationalization in our students. It is easier to teach by textbook and rule than to whip into action the yet unawakened minds of young students. But we must, however difficult the task. We must confront our students with new and different situations; give them cases and problems which perhaps have no set or standard solution; and in other ways challenge them to rationalize from principle to particular.

I must confess this is not easy. I flounder often in the attempt, and often fail. But the real teacher of the future will succeed here and will have many less failures.

Looking Ahead. We can only speculate about the future. What are our prospects for overcoming our weakness and reducing our failures in accountancy education?

Certainly, all will become more and more aware of the wide variations in the quality of education offered by our different colleges and universities. Recruiters already are turning to those schools which seem to produce the better product. The better high school graduates will turn more to the better schools. This increased realization of the superiority of one school over another will do more than anything else to raise the standards of the weaker institutions.

The economic position of the college teacher will be substantially raised. It must be if anything like adequate staffs are to be around to handle the great influx of students in the decade 1960-1970.

Accounting will attract more and better high school graduates as we confront them with the real challenge of accountancy.

Altogether I think that accountancy education of the future will be as superior to that of the present as that we have now is superior to what I had when I first started the study of accounting.

FOURTH SESSION

THURSDAY, MAY 17, 1:00 P.M.

The Ohio Union—East Ballroom

Presiding:

DEAN WALTER C. WEIDLER, *College of Commerce and Administration, The Ohio State University.*

Paper: "Corporate Accounting Standards under the Federal Securities Laws"

J. SINCLAIR ARMSTRONG, *Chairman, Securities and Exchange Commission, Washington, D. C.*

Presentation of distinguished accountant to The Accounting Hall of Fame

VICE PRESIDENT AND BUSINESS MANAGER JACOB B. TAYLOR, conferring honor

MAURICE E. PELOUET, *Chairman, Board of Nominations,* presenting candidate:

ANANIAS CHARLES LITTLETON

CORPORATE ACCOUNTING STANDARDS UNDER FEDERAL SECURITIES LAWS

By

J. SINCLAIR ARMSTRONG
Chairman, Securities and Exchange Commission, Washington, D. C.

It is a great pleasure for me to have the opportunity to address the Eighteenth Annual Accounting Institute of the College of Commerce of The Ohio State University on the subject of corporate accounting standards under the Federal securities laws. The 18 years during which this great university has annually sponsored this two-day gathering of distinguished scholars, practitioners and students in the accounting field are the years in which the great evolution of accounting standards has occurred, under guide lines and standards set by the Acts of Congress administered by the Securities and Exchange Commission.

Parenthetically, may I say, as a member and Chairman of that Commission, I feel a close relationship with this university. As an independent agency, the Commission is by statute under the surveillance of two standing Committees of the Congress. In the Senate the Committee which watches over the Commission is the Committee on Banking and Currency, of which your trustee and disinguished Senator, John W. Bricker, is a member. In my talks with him from time to time he has often spoken of his great interest in the growth and accomplishments of The Ohio State University, and of its College of Commerce, under whose auspices this Accounting Institute is held.

Before discussing accounting standards as such, I want to emphasize the great importance the accounting standards developed under guidance of the Securities and Exchange Commission, with the aid of the profession, over the past quarter century have had for the economy of America, and hence for the people of America. Good accounting is the essence of financial reporting. Good financial reporting to investors and security holders is the only way by which the public can be put in a position to make intelligent investment judgment. There are at the present time 2,238 issuers required by the Securities Exchange Act of 1934 to file financial reports with the Commission because their securities are listed and traded on national securities exchanges, and 1,104 additional issuers required by the Securities Act of 1933 to file such reports because of having made public sale of their securities in interstate commerce.

The development of the enormous body of financial information, by reports prepared under the accounting standards of the Securities and Exchange Commission and in accordance with accounting principles deemed by the accounting profession to be generally acceptable, with respect to these listed and publicly financed corporations has been a vital factor in the restoration in the past few years of investor confidence in the securities markets. This confidence was badly shaken in the 1920's and early 1930's, as a result of abuses in the securities markets. On continued public confidence in the securities markets of the country depends the ability of the privately owned system of productive enterprises to raise the capital which will be needed in enormous amounts to finance the industrial expansion required for our increasing population and higher standard of living in the years immediately ahead.

The capital requirements of American industry in the next decade are expected to be very much greater than those of the years just passed, but let me tell you of them briefly to give you a glimpse of the enormous amounts of money involved.

In the years 1946 to the present new records for industrial expansion were established and for public financing by business corporations. In this period business corporations spent $52 billion on increases in working capital and $196 billion of the funds required from internal sources, retained earnings, depreciation accruals and the like, but raised $63 billion of new money (net of retirements) from the sale of new securities and bank and mortgage financing. Furthermore, of the securities sold, 22 per cent were equities, that is capital stock. The confidence of the investing public in the securities of corporations can only be based on sound financial reporting. With that confidence continuing the enormous amounts of capital funds which must be channeled from the savings of the American people into our privately owned corporate enterprises will be raised and our free enterprise system will advance in accordance with our expanding needs.

With this larger orientation, now let me come to the more specific area of discussion, corporate accounting standards under the Federal securities laws. These are the laws administered by the Securities and Exchange Commission.

The rapid increase in the use of corporate forms of organization and the great size to which some corporations have grown, with the accompanying subdivision of ownership and the separation of immediate control of operating policies from the stockholder owners, have made reliable accounting reports a vital necessity for managerial control and investment management. While investors cannot expect to obtain from financial statements all the information necessary to the exercise of investment judgment, nevertheless financial statements come close to being the only common measure of comparison of different companies and are the basic sources of all financial information.

Accounting and financial information plays an important part in all of the work of the Securities and Exchange Commission. In the administration of the Securities Act and the Exchange Act accounting plays a most important role. These Acts have had the greatest influence on the development of the present character of corporate accounting standards. The important role accounting plays in the administration of the Securities Acts is foreshadowed in the Acts themselves.

The title of the Securities Act states that it is "an Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes."

It is designed to make available to investors the business and financial facts deemed by the Congress to be necessary for the investing public on which to base an informed judgment as to whether to buy new issues of securities being offered.

The title of the Exchange Act states that it is "An Act to provide for the regulation of securities exchanges and of over-the-counter markets operating in interestate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes."

This law provides for, among other things, the filing by listed companies of periodic financial reports. It provides for regulation by the Commission of solicitation by listed companies of proxies from their stockholders. It requires brokers and dealers to maintain certain records and file certain reports with the Commission. All of these provisions in most instances require the filing of financial statements certified by independent accountants. The aim of this legislation is broader than that of the Securities Act in that it is to provide the information to be used by the investor in determining what securities to buy, hold or sell. It also contains regulatory provisions regarding the stock exchanges and the over-the-counter markets.

The enactment of the Federal securities laws and the establishment of an administrative agency, the Securities and Exchange Commission, to effect recognition of the investor's interests have created unusual demands on accounting and the accounting profession and have had a forceful impact on the trend of accounting thought and development of reporting techniques. Under these laws the fundamental basis of regulation is disclosure—disclosure of all pertinent information concerning the securities and the issuers. Neither the Securities Act nor the Exchange Act gives the Commission authority to pass on the merits of any security, or to approve or disapprove any security. For this reason these laws are called disclosures Acts. They also include vital antifraud provisions.

The components of a matured investment judgment are not susceptible of exact methematical determination. Particular facts which induce the investor to buy or sell or hold are often extraneous to the business itself or even the industry. Judgment as to the future of the industry or the competitive position of a company in its industry, or judgment as to the ability of the management may be the immediate motivating force in reaching an investment decision. Such a decision to be an informed judgment, however, could be made only after an analytical study of the available financial information.

The backbone of the information to be used in arriving at such a decision is the operating history and financial position of the corporation as reflected in its financial statements. This is basic information. This factual information is the starting point for any analytical study, whether it be to review the operating efficiency of the company, to appraise its financial position or the caliber of its management, to formulate business plans, such as for expansion, retrenchment, or direction of sales effort, or for investment analysis.

The statements required in the Commission's forms are the conventional balance sheets, income and surplus statements and certain supporting schedules. The registration statement forms for new issues of securities usually require three-year income and surplus statements and in the prospectus to be delivered to the investor a summary of earnings for an appropriate period, usually not less than five years.

The form and content of the required financial statements are set forth in the Commission's accounting rules, known as Regulation S-X. This regulation does not purport to define accounting principles. It merely defines the extent of the detailed information required in conventional terminology and present accounting practice. It was worked out with the advice and cooperation of the accounting profession, and is under constant revision in the same spirit of cooperation.

The Securities and Exchange Commission has often been importuned to write accounting principles into Regulation S-X. We have even been petitioned to adopt rules requiring corporations to conform to advanced accounting theories, such as "economic depreciation." But the Commission has wisely left the development of accounting principles and practices to the accounting profession and the educators. This approach has been urged upon us in the past by leaders in both the practicing and the academic sectors of the profession.

This does not mean that we have abdicated our authority or delegated it to the accounting profession. The Securities Acts give the Commission authority to require financial statements certified by independent accountants. In most instances we require that the statements be certified by independent accountants and we have taken steps to insure that the accountants will be independent.

Likewise, the Securities Acts require that a broad schedule of information be furnished and leaves the Commission a wide latitude as to the amount of detail to be required, even to defining the method to be followed in the preparation of the reports. Section 13 (b) of the Exchange Act states:

> "The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, and in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income***."

But the Securities Acts do not attempt to define corporate accounting standards to be used in writing those rules and regulations. They do not even mention accounting principles. These matters are left to the discretion of the Commission.

Consequently, while our regulations use generally accepted accounting terminology and we expect financial statements filed with us to be prepared in accordance with generally accepted accounting principles and practices, as we believe that this will best indicate their significance and character, we are in no way limited to accepted accounting practice in obtaining such information as we deem necessary or appropriate for investors. Many requirements in Regulation S-X were not required by generally accepted practice at the time the rules were adopted. For example, Rule 3-19 of Regulation S-X requires disclosure in footnotes of assets subject to lien, intercompany profits and losses, defaults, terms of preferred shares, pension and retirement plans, restrictions on the availability of surplus for dividend purposes, and contingent liabilities. Likewise, Rule 3-20 requires disclosure of installment sales, intercompany profits and losses, depreciation and amortization policies, and stock options to officers and employees.

The Commission's staff has recently made a study of the stockholders reports of some 1,200 unlisted companies which have at least 750 stockholders of one class and $2 million of total assets. This study showed that while about 85 per cent of the reports gave a complete set of financial statements, that is, balance sheet, income and surplus accounts, and generally followed accepted accounting principles and practices, at least 50 per cent of them failed to give the type of information I have just mentioned.

Even more important than the extent of the detail of information required or the endeavor to obtain adequate information is the accuracy and integrity of the information obtained. The Commission attempts to restrict the financial statements to pertinent factual information and to avoid the inclusion of forecasts or evaluations of securities. It is the Commission's practice to test the information furnished for substantial truth and accuracy but to leave the investor to draw his own conclusions.

Financial statements filed with us are required to be prepared on the historical cost basis as determined by conventional accounting practices. They are in most cases required to be certified by an independent public accountant. Under both the Securities Act and the Exchange Act, the corporation filing must sign the registration statement or annual report through an authorized officer. In addition, in a registration statement under the Securities Act the principal executive officer, principal financial officer, and principal accounting officer, and a majority of the board of directors must sign the registration statement. The management is therefore responsible for the preparation and reliability of the financial statements, which are required to be reviewed independently by accountants who are not connected with the business. Thus there is a dual responsibility imposed upon both management and independent accountants for the financial statements. This dual responsibility is not satisfied if the accountant is not independent as defined in our rules and regulations, or if the management has left its accounting responsibilities to be performed by outside accountants. This does not, of course, prevent the management from relying on the report and audit of an independent accountant to the extent that they may legally rely upon the report of an expert.

Although we discourage persons filing registration statements and other statements and reports from including evaluations of the security being offered and forecasts of earnings, we do not underrate the importance of current values, economic and financial analysis, and interpretations and forecasts. But we consider that these are beyond the scope of financial statements and of the basic factual information required by the Securities Acts under their disclosure standards. A sharp distinction should be drawn between the presentation of factual information and interpretations, forecasts and conclusions. As a general rule, for a person preparing and certifying accounting data to go beyond factual information detracts from the reliability, integrity and usefulness of the report.

It is because the Commission considers the integrity and accuracy of this basic financial information of first importance that it has throughout its existence resisted the pressure to accept the reflection in financial statements of departures from historical cost. By historical cost is meant the appropriate cost basis as determined by conventional accounting practices and techniques. There are many problems connected with determination of historical cost. We do not, however, object to showing in a proper manner factual evidence of increases in value of assets during the time held by the corporation, or the effect on the operating results of financial position of changes in price levels.

While, in general, we adhere to the historical cost principle, we also have to deal with all problems which come before us in the regular course of business. For example, in certain instances we have not objected to the determination of an appropriate initial carrying value in excess of cost to the last purchaser in situations in which historical cost principles were deemed not to apply. These situations are concerned with the determination of original carrying value, usually to a new corporation under circumstances approaching arm's-length bargaining, and where the value of the assets in question have been substantiated by appropriate means. We do not, however, consider these determinations as judgments of principle, but rather as interpretations of conflicting principles. We do not consider them necessarily as precedents, but as each such problem arises we consider its own merits. We have indicated in recent discussions with representatives of the accounting profession our desire to review this area of accounting thought to determine whether a satisfactory expression of the principles could be developed.

In summary, the main aim of the Securities Acts is good financial reporting. Accounting does not encompass all financial reporting, but it is the backbone of financial reporting and is of vital importance in the administration of the Federal securities laws. It is most significant for corporate accounting standards under the Federal securities laws that the accounting profession, industry and the Securities and Exchange Commission have cooperated in the development of appropriate standards of reporting and disclosure to meet changing conditions. This progress must continue if the confidence of the American people in the corporate securities markets is to be earned in the years ahead, and this, as I stated at the beginning of these remarks, is of vital importance to the continued success of our free enterprise system.

ANANIAS CHARLES LITTLETON

The Board of Nominations of The Ohio State University Accounting Hall of Fame presents Ananias Charles Littleton.

Dean Littleton, after graduating in 1912 from the University of Illinois with an A. B. degree, joined the Chicago office of Deloitt, Plender, Griffiths & Co., where he remained until 1915. Hiram T. Scovill was also employed by the same firm at the same time, and when he left to join the faculty of the University of Illinois he asked Dean Littleton to join him. He accepted, and remained with the University of Illinois for 37 years, until his retirement in 1952. He was Assistant Dean of the College of Commerce and Business Administration from 1919 to 1921, and Assistant Director of the Bureau of Economic and Business Research of that College from 1921 to 1942. He received his A. M. degree in 1918, the Illinois CPA Certificate in 1919, and his Ph.D. in 1932.

For many years Professor Littleton was in charge of the graduate work at the University of Illinois. He assisted in developing a program leading to an M.S. degree in accountancy at the University of Illinois and the first such degree was awarded in 1922. Under his direction the first PhD. program in accountancy in the United States was developed at the University of Illinois and the first degree was awarded in 1939.

Dean Littleton has been active for many years in professional societies. He belonged to the American Institute of Accountants, American Accounting Association, Illinois Society of Certified Public Accountants, Beta Gamma Sigma, and Beta Alpha Psi, of which he was a founder.

He was President of the American Accounting Association in 1943, Director of Research from 1940 to 1942, on the Executive Committee from 1940 to 1947, and was the editor of the Accounting Review from 1943 to 1947. He served on several important committees of the American Institute of Accountants, including the Committee on Accounting Procedure, 1939 to 1941, Committee on Selection of Personnel, 1943 to 1947, and Committee on Accounting History, 1946 and 1947.

Dean Littleton wrote widely on accounting theory and the history of accounting. His "Accounting Evolution to 1900" is a most important contribution to the story of the development of accounting in this and other countries, and his "Introduction to Corporate Accounting Standards," written in cooperation with William A. Paton has been a standard work since its publication. He has also written an important book on *Structure of Accounting Theory*, and over one hundred monographs and articles have appeared in—The Accounting Review, Journal of Accountancy, The American Accountant, The Harvard Business Review, The New York Certified Public Accountant, The Illinois Certified Public Accountant, and other periodicals.

Because of his lifelong devotion to the practice, teaching and development of accountancy in the United States, his leadership in the professional associations to which he belonged, and his valuable contributions to the literature of the profession of accountancy, the Board of Nominations of The Ohio State University Accounting Hall of Fame is proud and happy to present Ananias Charles Littleton.

FIFTH SESSION

FRIDAY, MAY 18, 10:00 A.M.

The Ohio Union—West Ballroom

Presiding:

ROBERT N. WALLIS, *President, Controllers Institute of America, Inc.; Treasurer, Dennison Manufacturing Company, Framingham, Mass.*

Paper: "Partnership Distributions and Liquidations" (Copy of paper not available)

MAURICE AUSTIN, *Partner, Austin & Diamond, New York, N. Y.*

Paper: "Compensation Arrangements for Executives and Employees"

GEORGE DAVERIO, *Partner, Chilton, Stump & Daverio, Akron, Ohio*

COMPENSATION ARRANGEMENTS FOR EXECUTIVES AND EMPLOYEES

By

GEORGE DAVERIO
Chilton, Stump & Daverio,
Akron, Ohio

In discussing the subject "Compensation Arrangements for Executives and Employees" this morning, I shall try to cover in general terms the field of employer-employee relations, in so far as federal income taxes are concerned. In the many years that have passed since the enactment of the so-called "social security" legislation providing tax-free unemployment and old age retirement benefits, employers and employees have continuously searched for areas within which more and more benefits can be provided for employees at minimum costs to both the employer and the employee.

The employer's net costs are naturally kept at a minimum if he can obtain immediate tax deductions for all payments to his employees, or expenditures and contributions for their benefit. The employee is best served if his current income taxes are kept at a minimum on benefits received and deferred to the greatest possible extent on benefits to be realized in the future. Congress, the Treasury Department and the Federal Courts have done much in recent years to aid employers and employees in the attainment of their common objectives. It is our sincere hope, of course, that these areas will continue to expand.

In my discussion I shall not attempt to cover the every day payments of salaries and wages because they involve no tax problems. Nor shall I attempt to cover the subject of pensions, because in most cases, they have already been considered and acted upon by employeers. Rather, I would like to discuss for you certain *plus* items for executives and employees, such as:

Exempt Income
Fringe Benefits,
Deferred Compensation,
Stock Options, and Profit-sharing
Trusts

with respect to which, something more may undoubtedly be done to improve employer-employee relations by each and every company.

EXEMPT INCOME. WHAT ITEMS ARE OF SPECIAL SIGNIFICANCE IN THIS AREA?

I would suggest considering sick benefits, death benefits and honorariums, in this particular area. The first two items are provided for specifically by law, while the courts must be given credit for the third item even in face of determined opposition in recent years by the Treasury Department.

In regard to sick pay, when an employee is absent from work because of illness or personal injury and his employer continues paying him wages or salary, such payments are exempt from income tax to the employee up to $100.00 per week. If he is hospitalized, the income is exempt from the very first day, but if he is not hospitalized, the exemption begins only after seven days. While most employers continue paying salaried people during periods of illness, few have a policy of continuing wage payments to hourly-rated employees. However, a provision for sick pay in limited amounts for limited periods is beginning to be found in more and more union contracts. If an employee has qualified for the exemption, it will continue until he returns for work at his usual place of employment. If he returns for only part-time work, say an hour or so per day, he loses his exempt status and must pay income tax on his total compensation received thereafter. Until an employee therefore can do a substantial part of a day's work, might it not be well to permit him to remain at home and thus continue to receive exempt income, up to the statutory limitation, of course? In addition, it might be helpful for the employee to be advised at the end of each year of the amount he was paid during his absence from work on account of sickness or personal injury.

Upon the death of an employee, the law exempts from tax the amounts up to $5,000 received by his beneficiaries from his employer, *if* the amounts paid are designated "death benefits." If the employer therefore has had a policy of paying to beneficiaries of a deceased employee, an amount bearing some relation to length of service and rate of compensation, such payments if actually designated "death benefits" will constitute exempt income up to the statutory limitation. It might be advisable then to designate all after-death payments of unearned compensation as "death benefits" and to notify the beneficiaries that it is exempt from income tax.

If an officer of a corporation dies and by reason of the valuable services he has rendered to the corporation, the Directors authorize the payment of an honorarium to his widow, such amounts are deductible by the corporation and based upon a number of court decisions, are not taxable to the widow. The courts have consistently held that such payments constituted non-taxable gifts to the widow even in view of a contrary ruling by the Treasury Department. The amounts paid widows are usually equivalent to her deceased husband's compensation for at least one year. The payments in most cases are made on a monthly basis over a period of one or two years. It is generally agreed that honorarium payments may be made to a widow in addition to "death benefits." In order to eliminate the recurring litigation by widows with respect to honorariums received, it is sincerely hoped that the Treasury Department will soon reverse its ruling on the taxability thereof and accept the unanimous decisions of the courts on this item.

IN THE NEXT AREA, "FRINGE BENEFITS", WHAT TYPES OF ITEMS MAY BE CONSIDERED?

This group of items usually includes non-cash benefits to employees, which are not taxable to them but are still deductible by the employer. In some cases, certain types of fringe benefits are practical for only a relatively small number of employees, usually the executive group. Particular care must be exercised in closely held corporations, where the Treasury Department may assert that the payments for these items, if liberal, were either dividends in disguise to the executive-shareholders or not ordinary and necessary business expenses.

The most common items in this group are: accident and health insurance, expense paid vacations, split-dollar life insurance and tax-free meals.

The law specifically covers the subject of accident and health plans. The emphasis is on the word "plans." If an employer has a plan, usually an insured one, the payments made therefor are fully deductible by the employer. The employee realized no taxable income at the time his employer makes his contribution nor later to the extent that he receives actual benefit payments to reimburse him for the medical care of himself, his wife, and his dependents. However, any reimbursement for medical expenses previously deducted is taxable.

In the case of fully or partially paid-for vacations, care and caution are the watchwords. Many companies in this territory own homes or lease apartments in Florida or own or lease camps in Canada. They make these facilities available to their employees and also some customers at designated times of the year. All expenses while there, and at times, traveling expenses to and from, are paid by the company. If reasonable with respect to the individual employees and if executive-stockholders are not especially favored, all expenses should be deductible by the company. Also, the employees should not be taxed on the fair-market value of the benefits enjoyed.

The Treasury in a recent ruling approved the participation by employers in the purchase of so-called split-dollar life insurance on employees' lives. It provides a unique method of assisting employees in buying ordinary life insurance. The employer is permitted to loan the employee interest-free, an amount annually equivalent to the increase in the cash surrender value of the policy. The employer's loan is always fully-secured because it is identical in amount with the cash-surrender value. The employer is, for all practical purposes, co-owner and co-beneficiary under the policy to the extent of the loan. The program is carried out through a formal contract entered into by the employer and the employee. Generally, it is most practical in cases of younger executives in need of substantial amounts of insurance.

As an example, let us assume that an employee, age 40, wishes to buy a $100,000 life insurance policy. The first year he pays the full gross premium of $3,910. The next year, the net premium of $3,209 is paid, $2,600 by the employer, and $609 by the employee. By the eighth year, the employer will have paid $16,700 and the employee $5,865. If the employee died at this point, the employer would receive $16,700, the amount of the loan, and the employee's beneficiaries would receive the balance of $83,300. Incidentally, if the employer continued making the payments for 25 years or until the employee reached age 65, he would have a fund of $76,300 available for making possible retirement payments to the employee.

The law specifically provides the conditions under which an employer may provide tax-free meals to employees. The two-fold tests to be met are:

> *First*—the meals must be provided for the convenience of the employer, and
>
> *Second*—the meals must be furnished on the business premises of the employer.

It would appear that a strong case could be made for furnishing meals to executives in a private dining room on the employer's premises.

In addition to those I have just mentioned, I am sure that most of you can appreciate that there are a number of other fringe benefits available for executives and employees, that require no detailed explanations such as the free use of company cars, club memberships and the purchase of company products at cost.

IN THE AREA OF DEFERRED COMPENSATION, WHAT ARE THE POSSIBILITIES?

The possibilities I would say, are good for the larger companies but not so good for the smaller ones. I use the word "deferred" in connection with this discussion of compensation because of its general usage in every day conversations. What we have in mind really is to extend the period of compensating key people beyond the time of their full employment by the company. The most practical way of accomplishing this is by means of individual employment contracts providing for:

(1) a fixed annual salary for each of the remaining active working years,
(2) a fixed annual salary thereafter for a specified number of years or for life, and
(3) a condition that the compensation during the latter period be paid only if the employee holds himself available for consultation from time to time and that he will engage in no activity detrimental to the interests of the company. This condition should be one of substance and not just a sham.

The compensation payments under such a contract are taxable to the employee and deductible by the employer, as and when made. The principal advantage to the employee is that he will receive compensation afer he retires at reduced tax rates. The principal disadvantage to the company is the continuing liability after the employee has retired. Generally, it is not advisable tax-wise to fund this liability, because the employer may under certain circumstances never secure a deduction, and likewise the employee may find that he is subject to income tax on the fund before he receives any part of it, under the principle of constructive receipt. Hence, the employer and the employee must rely on the continued ability of the company to meet its obligations under the contract.

I think it might be well at this point to say a few words about G.A.W., guaranteed annual wage. As you know, plans to provide supplemental unemployment benefits to certain auto workers become effective June 1, 1956. Our Ohio B. U. C. administrator has ruled that unemployed Ohioans cannot receive full state benefits and supplemental private benefits at the same time because of the present definition of "remuneration" in the Ohio law. If the law is amended next year to permit such supplemental benefit payments, Ohio employers may then be faced with the possibility of providing another form of "deferred compensation" for its employees. The income tax consequences thereof have already been decided by the Treasury Department. The employee must include all such supplemental benefits received in his taxable income and such payments are subject to withholding tax, if sufficient in amount.

The employer is permitted to take a deduction for all of his contributions to an independently controlled Trust Fund created for the purpose of providing such benefits to employees pursuant to a collective bargaining agreement. The Treasury ruling covering this subject is very specific and I therefore recommend that it be carefully read by all employers contemplating G. A. W. discussions with union representatives.

IN REGARD TO STOCK OPTIONS, WHAT CAN BE DONE?

The principal objective of stock options is to provide a method by which employees may acquire a proprietary interest in the company with resultant dividend income and the possibility of realizing capital gains. The tax law provides definite rules for "Restricted Stock Options." All other options are commonly referred to as "unrestricted" and their tax status is determined under the 1939 Code and the rulings and court decisions arising thereunder. For example, if the Treasury Department should decide that an option was "compensatory", one set of rules would apply, if however, they decided it was "proprietary", a different result would obtain. They have even ruled that a stock option given to a wife of an executive, which she exercised, using her own funds, involved taxable compensation to her husband. Therefore in view of the uncertainties involved with "unrestricted" options, it is generally agreed that they should be avoided in most cases. With that in mind, I shall confine my remarks to the statutory "Restricted Stock Options."

Generally speaking, many of the larger companies, after obtaining stockholder's approval, have granted to key employees, "Restricted Stock Options." These represent rights given the employees to buy a given number of shares of the company's common stock over a specified period of years, usually five. The price is fixed in the option agreement usually at 95 per cent or more of the market price on the date of the option. The option is non-transferable except at death. If the stock acquired by the employee upon the exercise of the option is held for a period of six months *and* at least two years from the date of the option, then any gains realized from the sale of the stock is reportable as long-term capital gain.

If the option price is less than 95 per cent of the market price or if the employee and his family own more than 10 per cent of the stock of the company, other statutory rules apply that make the use of options less attractive.

If the employer company does not have its stock listed on one of the securities exchanges, the fair market value of its stock should be determined by an independent investment appraiser for option purposes. To make the option attractive to key employees, some arrangement would also have to be made to provide a buyer for the stock when the employee wished to sell. If this were not practical, perhaps the company could option stock in a subsidiary company to its employees. There are few companies whose activities cannot be deducted through multiple corporations. The employees of the parent company would be given the option to buy only a minority interest in the subsidiary company. The capitalization of the subsidiary would be kept at a minimum so that its earnings would multiply the value of the stock quickly. After a designated time, the parent could buy the subsidiary stock from its employees when and as they wished to realize their capital gains.

PROFIT-SHARING TRUSTS. WHAT ARE THEY AND WHY ARE THEY BECOMING SO POPULAR?

A Profit-Sharing Trust is exactly what its name implies. It is an actual Trust created by an employer for the exclusive benefit of his employees. The trust fund is built up principally by annual cash contributions from the profits of the company. The percentage of the profits to be contributed and all of the other terms and provisions of the Trust are set forth in a formal Trust Agreement executed by the Company and the named Trustees. The agreement is submitted to the Treasury Department for approval and if it complies with the requirements of the Law, Treasury Regulations and Rulings, it will be approved and the company so advised in writing. Thereafter,

(1) all contributions by the company are deductible on an accrual basis,
(2) the earnings of the Trust are tax-free, and
(3) the employes or their beneficiairies pay no income tax until they actually receive distributions from the Trust.

What more could an employer want? What more could an employee want? The fact that there are approximately 10,000 Treasury approved plans in operation, I think, is evidence that here at last, we have a statutory plan of providing maximum employer-employee benefits at minimum costs to each. It is particularly adaptable to small business. In the last quarter of 1955, the Treasury Department approved 350 profit-sharing plans with an average of 53 participating employees per plan.

What are the essential features of a Profit-Sharing Trust?

(1) The company contributes a percentage of its profits to the Trust annually.

(2) The contributions upon receipt by the Trustees are credited to the accounts of participating employees usually on a point system.

(3) The Trust Funds are invested and reinvested by the Trustees in the manner provided for in the Trust instrument. They may not purchase securities of the employer, however, without the prior consent of the Treasury Department.

(4) Earnings and profits of the Fund are credited annually to the accounts of participating employees on the basis of the respective dollar balances in their accounts at the beginning of the year.

(5) In the event an employee retires, dies or becomes permanently disabled, he or his beneficiaries receive the entire balance in his account.

(6) If an employee terminates his employment prior to retirement, he will receive a percentage of the balance in his account at the beginning of the year, dependent upon the number of years he has been a participant. The amount which he forfeits by leaving will be credited to the accounts of remaining employees on the same basis as Trust earnings.

(7) The Trustees give each participating employee a detailed statement of his account after the close of each year.

(8) The company may discontinue the Trust at any time, in which event the Fund is distributed to the participating employees on the basis of the balances in their respective accounts.

Now a word or two of explanation about some of these essential features. When the Treasury Department issues its regulations in final form covering this subject, it is anticipated that no fixed formula of annual contributions by the employer will be required. In other words, the regulations will probably provide that the employer may contribute any amount he wishes year by year, subject of course to the statutory maximum limitation of 15 per cent of the annual compensation of participating employees.

The employer must determine and define the classification of employees that will participate, and the required length of service to become eligible. The classification, and the allocation of contributions and benefits under the plan must not discriminate in favor of employees who are officers, shareholders, supervisors or highly compensated. The point system referred to previously is usually based upon length of service and annual compensation. For example, 1 point is allowed for each 6 full months of service, and 1 point for each $100 of annual compensation, with a limitation on compensation points so as not to discriminate in favor of highly compensated employees.

In case an employee terminates his employment, the amount distributable to him may be paid in cash or kind, in a lump sum or in periodic installments, as provided for in the Trust Agreement. If the amount is paid in a lump sum, he may report same in his federal income tax return as a capital gain.

If an employee dies and his designated beneficiary receives the balance in his account, such amount up to $5,000 is exempt from income tax as a "death benefit." Also, such amount in its entirety is excluded from the employee's estate for estate tax purposes.

From this thumbnail sketch of a Profit-Sharing Plan, it would appear evident that in many cases, it can be an important part of a "compensation arrangement" for executives and employees. It enables an employer during profitable years to make a substantial contribution toward the financial security of his covered employees. It creates in employees not only the incentive to make an effort to contribute more to the success of the business but also to continue his employment. Not only does his continued employment increase his participation in annual allocations of contributions, earnings and forfeitures but also his vested percentage in his own account. As employees see their accounts grow year by year, they realize and appreciate that here is a fund that will help to provide additional financial security for themselves and their families. It is most certain to improve employer-employee relations.

SIXTH SESSION

FRIDAY, MAY 18, 12:30 P.M.

The Ohio Union—East Ballroom

Presiding:

O'FERRAL ESTES, *General Auditor, Capitol Airlines, Washington, D. C.*

Presentation of Hermann Clinton Miller Memorial Scholarship

FRED DENNIS, *President of The Ohio Society of Certified Public Accountants, making presentation to* ROBERT D. NEUBIG

Paper: "The General Accounting Office Today"

KARNEY A. BRASFIELD, *President, Federal Government Accountants Association; Assistant to the Comptroller General, Washington, D. C.*

SIXTH SESSION

Introductory Remarks

Mr. Fred Dennis: All men are dreamers. Some men are *only* dreamers. Hermann Miller was a great dreamer and a great builder. He was largely responsible for the conception and building of this Institute on Accounting. He played a distinguished part in the Ohio Society of CPA's.

His part in the development of the Department of Accounting at this great university is testified to not only by his colleagues but by the host of alumni, to many of whom he was teacher, counsellor, and friend. Hermann was also active in all of the significant organizations relating to accounting in all of its broader aspects.

As it must be with all men of great vision who pass suddenly from this scene, there were dreams which Hermann had not been able to implement. One of these dreams was the establishment of a fund to provide for assistance to graduate students at this university who were preparing themselves to become teachers of accounting. Certain of his close friends and associates were aware of this dream. They too were men of vision.

Desiring to do something constructive to honor Hermann Miller's great contributions to the accounting field in its broadest sense, they conceived the idea of an annual award to a graduate student in the Department of Accounting.

They conveyed their desire to Mrs. Miller and secured her approval of the establishment of an appropriate fund. The university's approval was also secured. Thus the Hermann Clinton Miller Memorial Fund was launched.

Many distinguished men in many fields lent their names as sponsors. This is gratefully acknowledged. Invitations to contribute to this fund were circulated and the response to date has been very gratifying. At present, there is in the fund more than $7000, and we have promises of additional contributions. Contributions are from many fields. We invite each of you who has not done so to join with us by contributing to the Hermann Clinton Miller Foundation, care of the Department of Accounting, The Ohio State University.

In every undertaking of this kind there is usually one person who sees to it that the job gets done. There was such a man in this instance. He had, of course, the enthusiastic assistance and advice of many distinguished men. This man has, in my opinion, done a splendid job. I feel that it is therefore appropriate that he be recognized and that he be accorded a generous round of applause. Ladies and gentlemen, the man I have been talking about is the president-elect of the Ohio Society of Certified Public Accountants, Mr. James Buccalo.

Now, ladies and gentlemen, I am informed that the Department of Accounting of The Ohio State University has selected the winner of the first scholarship granted under the terms of the Hermann Clinton Miller Memorial Fund. Mr. Buccalo, will you please present the graduate student who has been selected by the Department of Accounting to receive this award.

THE GENERAL ACCOUNTING OFFICE TODAY

By

KARNEY A. BRASFIELD,

Assistant to the Comptroller General, Washington, D. C.;
President, Federal Government Accountants Association

Mr. Estes, members of the Institute on Accounting and guests:

When those planning the Institute suggested the possibility of my participation in your program and that it be a discussion of what is going on in the General Accounting Office today, I asked myself the question: "Why should this group be interested in the General Accounting Office?"

A number of possibilities came to my mind—

1. As a taxpayer, you might well inquire concerning the audit activities of the General Accounting Office—the agency which serves as the independent auditor for the Congress — your elected representatives.
2. As an accountant, you might well inquire concerning the manner in which the Comptroller General is carrying out his responsibility to prescribe accounting principles and standards for the guidance of the heads of executive agencies who, in turn, have a statutory responsibility to install and maintain adequate systems of accounting and internal control.
3. As a citizen interested in the improvement of the public service, you might well inquire what contribution the General Accounting Office is making to the many current efforts to increase the efficiency of the Federal Government. For example, what are the views of the Comptroller General on the Hoover Commission recommendations in the field of budgeting and accounting?

A complete response to any one of these three questions would more than exhaust the time set aside for this discussion but I will endeavor to deal with each, to some extent, in addition to some general observations.

The most prominent single characteristic of the current situation in the financial management area in the Federal Government today can be identified as "evolutionary change." The General Accounting Office is a part of this environment and has contributed much to create and sustain it. After many years, the older concepts of accounting and auditing which were tied almost solely to "fidelity and historical record keeping" have been modified to embrace modern concepts of "service to management and effective internal control."

In its earlier way of life the General Accounting Office was largely a thing apart from the stream of day-to-day activities. Its auditors ordinarily worked from documents forwarded to a central point—its bookkeepers maintained a duplicate of the agency ledgers. Great illusions of precise control were created. Today, the General Accounting Office auditor or systems accountant is most likely to be found in the office of an executive agency—engaged in an examination of the internal controls of the agency, assisting agency accountants in the solution of their systems problems, discussing program matters with the management of the agency, or, perhaps, presenting the results of his work to a Congressional committee. The extent of this basic change in approach—i.e., from the review of literally millions of individual transactions to professional accounting and auditing concepts—can be simply illustrated by pointing out that tenants, other than the General Accounting Office, today occupy more than 40 per cent of the fine modern office building built for the General Accounting Office use based on needs developed under earlier concepts.

The General Accounting Office professional staff of accountants and authors today numbers about 1200; of this, 70 per cent are college graduates. Over 300 are Certified Public Accountants—about one-fourth of the staff. About 65 per cent of our 200 top supervisors are CPA's. The majority are members of one or more professional organizations. I should hasten to add that there are similar developments in many of the executive agencies.

Let us turn now to the audit activities of the General Accounting Office. The beginning point for the evolutionary period still underway was the 1945 statute providing for a commercial-type audit of Government corporations. The initial efforts to borrow public accounting concepts and practices per se have been modified to a degree as illustrated by the general objectives of the so-called "comprehensive audit" program which are to determine whether

1. The agency is carrying out only those actiivitieis or programs authorized by the Congress and is conducting them efficiently and in the manner authorized. Where appropriate, we will also review whether the authorized activities or programs effectively continue to serve their originally intended purpose.
2. Expenditures are made only in the furtherance of authorized activities and in accordance with the requirements of applicable

laws and regulations (including decisions of the Comptroller General).

3. The agency collects and accounts properly for all revenues and receipts arising from its activities.
4. The assets of the agency or in its custody are adequately safeguarded and controlled and utilized in an efficient manner.
5. Reports by the agency to the Congress and to the central control agencies such as the Bureau of the Budget, Treasury Department, and General Services Administration disclose fully the nature and scope of the activities conducted and provide a proper basis for evaluating the agency's operations.

This type of audit program is being extended as rapidly as staff facilities will permit. A number of departments and agencies, such as the Department of Agriculture and the Department of Interior are, for the most part, audited on this basis. Other types of audit at the site of operations have been instituted, for example, the audit of payrolls in civil agencies is performed at the site.

Significant progress in the audit of the Department of Defense under the comprehensive audit program is just now getting underway, although, of course, the centralized or voucher-type audit with significant improvements has been continuously carried on. Moreover, the audit of cost contracts was decentralized during World War II. It appears likely that some facets of our Defense audit program, such as pay and allowances of military personnal, may best continue on a centralized basis indefinitely. As a part of our Defense audit program, our audit of cost contracts is in the process of being revitalized to adapt some of the features of the comprehensive audit approach to this work.

In all of our audit activities, we are vitally interested in fostering the development of adequate internal audit programs within the executive agencies. Only in this way is management likely to provide itself with all of the tools necessary to do a fully effective job. Moreover, the staffing problem inherent in applying the comprehensive audit approach Government-wide is such that it can only be done successfully if most of the major agencies have an effective internal audit program. Good progress has been made in a considerble number of agencies. A case in point is the Army Audit Agency. However, the keen competition for qualified personnel, both in and out of Government, obviously will be a major factor in building up the professional staff of both the General Accounting Office and the agencies for many years to come.

It is difficult to find any unit of measure which can serve as a yardstick to illustrate the current situation in the audit efforts of the General Accounting Office, but I can give you some illustrations.

In the calendar year 1955, the General Accounting Office rendered 107 audit reports to the Congress and about 200 to individual departments and agencies. These reports vary widely because of the scope of the activities under examination. Many are broad in scope and contain a variety of recommendations for improvements. Occasionally, our work results in a very specific saving which can be identified. For example, a review of Air Force procedures for determining spare aircraft engine requirements and for controlling the related procurement, disclosed over-procurement on two series of engines still in production and that arrangements were being made for procurement of additional engines of another series, although excess engines of a similar series were available. The Air Force took action promptly when this matter was brought to their attention and made estimated savings in excess of $60 million. Of course, we do not come up with many cases as simple and dramatic as that one but the idea is multiplied many times over in our work, and it gives you some perspective on the need for an independent review of agency activities. It also indicates the importance of prompt agency action if satisfactory results are to be achieved.

Some indication of the viewpoint of outside groups concerning General Accounting Office audit concepts and efforts can be drawn from the fact that the only recommendation made in the budget and accounting report of the second Hoover Commission relating to audit was "***to make an intensive study to determine the adequacy of internal auditing in Government agencies and what steps should be taken to improve it."

In its February 1956 report on "Review of Audit Reports of the Comptroller General" the Senate Committee on Government Operations said, in part, as follows:

> "***This continued emphasis on the value of audits by the Comptroller General assures that the legislative committees will be provided with detailed information relative to the fiscal and other operations of the various Federal agencies which would not otherwise be available to them.***"

At another point, the report states—

> "As the quality of agency accounting improves, the amount of detailed auditing required to be performed by the General Accounting Office is reduced. This enables that Office to devote further effort and energy to appraising the overall effectiveness of the discharge of the agencies' financial responsibilities, and to supply the

Congress with information needed in the appraisal of program operations, budgetary requests, and fiscal legislation. At the same time it affords an effective basis for settling the accounts of accountable officers without sacrificing any necessary controls over receipts and expenditures."

It is obvious that in an audit activity of this scope and diversity some portions of it are not as effective as they could be. However, we do believe our progress is satisfactory and we shall continue to strive to improve it further.

The Government-wide program to improve the effectiveness of financial management is known as the Joint Accounting Improvement Program. It represents the combined efforts of the Treasury Department, the Bureau of the Budget and the General Accounting Office, plus the participation of the respective operating agencies insofar as each is individually concerned. This program will soon be 10 years old and a great deal has been accomplished under it.

The initial step was to recognize for the first time the inherent management responsibility of the head of each agency to install and maintain adequate systems of accounting and internal control. It also was recognized that in order to preserve legislative control of appropriations and expenditures in accordance with the long-established policy of Congress, the Comptroller General, as an agent of the Congress, should prescribe basic accounting requirements in terms of principles and standards.

With reference to the manner in which the Comptroller General has carried out his responsibility to prescribe principles and standards, the second Hoover Commission has this to say—

> "The Comptroller General's responsibility for prescribing the principles, standards and related requirements for accounting to be observed by each executive agency has resulted in his issuing a statement of accounting principles and standards for guidance of the agencies. These principles and standards which were developed in consultation with the executive branch have been set broadly, are sound, and permit flexibility in their application. They have been helpful and in our opinion are in complete harmony with the proper objectives of accounting improvement in the executive branch."

The objectives and evolutionary character of the present effort was described by John W. McEachren in the September 1955 *Journal of Accountancy* as follows:

> "It is not the purpose of this article to arouse new indignation by pointing again to Washington's alleged shortcomings. Instead,

it has the more cheering purpose of calling attention to the little known fact that a purposeful, productive campaign is afoot to modernize the entire structure of government accounting along lines that the taxpaying public, and the accounting profession particularly, might well applaud.

"What is happening lacks the dramatic impact of a revolution. But it represents something better, a planned evolution which promises to work the most significant transformation in our government's financial management since the days of Alexander Hamilton.

"Both the executive and legislative branches have important stakes in this long-term effort. And both branches are cooperating in a joint endeavor to effect this transformation and to reach these explicit goals:

"1. To bring to all of the government's diversified activities the most appropriate and useful of modern accounting principles and techniques.

"2. To enable government agencies to ascertain the cost of their various activities, as many of them have been unable to do in the past.

"3. To provide better fiscal controls which will permit the executive to budget projected activities more realistically; assist the legislative in its appropriating functions; and allow the taxpayer to see more clearly how his money is spent and what it buys.

"4. To reduce expenditures wherever possible by improving the efficiency and effectiveness of management."

The first changes to be made under the joint program were in those processes of the central fiscal agencies (General Accounting Office, Treasury and Budget Bureau) which, commonly, have been referred to in the past as "central paper mills." More important, it was these rigid processes which discouraged, if not actually prevented, effective accounting for management purposes at the bureau or agency level. Generally speaking, this type of change is behind us at the central agency level.

The second phase, namely, securing effective accounting in the operating agencies is moving ahead. There is no simple yardstick or common denominator by which to measure either the progress which has been made or the job yet to be done. Both are highly significant. For example, I can tell you that as of the end of the last fiscal year operating agencies' financial statements showed assets under accounting control in the amount of $156 billion, and this figure does not include substantial progress in some activities of the Department of Defense where dollar figures are available but have yet to be tied into their formalized accounting records. On the other hand, unsolved problems can be illustrated by pointing out that major segments of the fixed assets, i.e., plant and equipment, are not yet set up on the books.

There are many other facets to this problem which need to be considered to give it perspective. For example, in one way or another, the Federal Government operates activities similar to almost every type of private enterprise, that is, banking, insurance, power generation and marketing, merchandising, manufacturing, transportation, communication and so forth. In addition, it carries on those activities unique to a sovereign government such as the collection of taxes. Accordingly, if management is to be effectively served, we must have many types of accounting and financial systems, as well as the accounting directly related to the obtaining and spending of appropriations.

There have been many impressive illustrations of direct savings growing out of the joint accounting program. I refer to such accomplishments as:

1. Improvements in the money order system by the Post Office Department adopted several years ago which resulted in savings of $6 million per annum. Significant additional improvements have been made since and still are in prospect.
2. Conversion of paper checks to punch cards at a savings of more than three quarters of a million dollars annually.
3. Reduction in the effort represented by the preparation of more than 2.8 million vouchers annually through the use of a schedule rather than an individual voucher as the means of authorizing payment by the Treasury Disbursing Officer of amounts owed.
4. Combining the payment and reconciliation processes in the handling of Government checks by the use of high-speed computers will save in excess of $2 million annually.

Important as these and many, many other paperwork simplificaitons have proven to be, the intangible and less measurable savings from providing management with adequate accounting and cost data are far more significant. Only when programming, budgeting, accounting and reporting have been tied together through an integrated accounting system providing for accrual accounting does the Congress and the executive branch reap the full benefits contemplated by the basic principles of the joint accounting program. Only then will Congress and management know the real costs of the program being carried out.

I can summarize this part of my discussion by pointing out that the groundwork has been laid at the central agency level, and every year substantial progress is being made in many agencies under the Government-wide cooperative effort jointly sponsored by the Treasury Department, the Bureau of the Budget and the General Accounting Office. However, adoption of the basic recommendations pertaining to budgeting and accounting contained in the Hoover Commission report, which I wish to discuss next, would expedite progress and aid in reaching higher standards.

The Budget and Accounting Report of the second Hoover Commission was released to the Congress in the summer of 1955. The Comptroller General was the first public official to take a position on the recommendations contained in the report. This was done in October, 1955, in response to a request from the Chairman of the Committee on Government Operations of the House of Representatives.

In his response, the Comptroller General unequivocally supported the basic financial recommendations, namely,

1. formulation and administration of agency budgets on a cost basis,
2. accrual accounting,
3. property accounting,
4. simplification of fund control processes, and
5. annual accrued expenditure appropriations.

I might add, that we in the General Accounting Office have been advocating these reforms since the advent of the joint accounting program in 1948 with the exception of changing the basis of appropriations, which is a more recent development.

In the case of certain recommendations dealing with organization matters within the executive branch and with reporting functions, the Comptroller General questioned the desirability of legislative action as opposed to a more flexible approach through administrative action.

More recently, these same views were expressed by the General Accounting Office in testifying before the Reorganization Subcommittee of the Senate Committee on Government Operations and will be reiterated again next week in our appearance before the House Committee on Government Operations.

In each case the evolutionary approach to continued progress is urged as a fundamental proposition, although the need for basic legislation in such matters as changing the basis of appropriating funds from the "obligation" concept to "'annual accrued expenditures" is recognized.

The position of the executive branch on the Hoover Commission report on budget and accounting was set forth in the release of an exchange of correspondence between the President and the Director of the Bureau of the Budget on April 29, 1956. Here again, the basic financial recommendations were concurred in so that, subject to necessary action by the Congress, there is every reason to be optimistic about continued progress.

On May 10, 1956, the President followed this up with a message to the Congress urging support of the Commission recommendations and enactment of appropriate legislative provisions.

I realize that I have given you a report which emphasizes the cheerful side of our picture. We also have our problems. Nor would I want to leave the impression that all officials within the Government or the Congress are in accord with the Hoover Commission recommendations or the kinds of progress generally being made under the joint program. We encounter the same human resistance to change in this effort as is always the case in any similar endeavor. Perhaps, the most discouraging group are those few in high places who are unwilling to try to adapt to Government the progressive budget and accounting practices embodied in modern business management concepts. Their oft repeated plea is that Government must be "different" and that outsiders do not "understand." Fortunately, they are few in number.

In the General Accounting Office, our greatest problem is to build up a higher quality staff of accountants and auditors in today's highly competitive market. Our approach to accounting systems work and audit permits no compromise with quality. We have recently instituted a number of steps in our recruiting and training efforts which we hope will substantially contribute to the solution of our problems over the long pull but we know that we are faced with certain inherent disadvantages such as our pay scale. These problems are, of course, Government-wide and are not confined to the accounting field.

In conclusion, I would summarize the present situation by saying, the foundation has been laid and tested, the increase in tempo during each of the last several years is plainly evident, the leadership is strong and united, and, if the Hoover Commission recommendations can become the vehicle for strong support from private citizens, these next two or three years should see progress far greater than we could have dreamed of a few years ago.

I thank you.

CONFERENCE ROSTER

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Allen, Walter P., Springfield City Hospital, Springfield
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Arnold, Dorsey, Haskins & Sells, Cleveland
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Johnson, Marvin, Arthur Andersen & Co., Columbus

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Kauffman, Stanley C., Arthur Andersen & Co., Cleveland
Kayati, S. G., Warner and Swasey Co., New Philadelphia
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Keenan, Richard D., Price Waterhouse & Co., Cleveland
Keller, Lawrance, KKMC, Columbus
Kelsey, George W., Kelsey & Kelsey, Cleveland
Kemp, Zail, Columbus & Southern Ohio Elec. Co., Columbus
Kempner, Jack J., OSU, Columbus
Kercher, J. W., Ernst & Ernst, Dayton
Ketner, Forrest G., OSU, Columbus
Kindinger, Don R., Ernst & Ernst, Columbus
King, Dale E., Arthur Young & Co., Cleveland

King James E., Shenango-Penn Mold Company, Dover
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Mills, A. R., Peoples Development Co., Columbus
Minnear, R. E., Touche, Niven, Bailey & Smart, Dayton
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Opatrny, Donald C., Lubrizol Corp., Cleveland
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Pulsinelli, Frank P., KKMC, Columbus

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